



United Security Bancshares

2011 Annual Report

UNITED SECURITY BANCSHARES

Corporate Profile

Headquartered in Fresno, California, United Security Bancshares was formed in 2001 as a bank holding company to provide commercial banking services through its wholly owned subsidiary, United Security Bank. Founded in 1987, United Security Bank is a state-chartered community bank, which operates eleven full-service branches and one construction lending office in Fresno, Madera, Kern, and Santa Clara counties. United Security is a customer-oriented, full-service financial institution engaged in providing a wide range of competitively priced commercial banking services primarily to the business community and individuals located in the central and southern San Joaquin Valley, as well as the Campbell area in Santa Clara County.

At United Security Bancshares, we are committed to improving shareholder value and delivering the highest quality products and services while being responsive to the changing needs of our customers and business markets. Our primary business strategy is to increase market share in the local communities we serve, as well as to expand into new markets when sound business opportunities present themselves.

United Security Bancshares' common stock is traded on NASDAQ under the symbol "UBFO". For more information, please visit us at www.unitedsecuritybank.com.



...response ability

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United Security Bancshares

Selected Financial Highlights

	At or For the Year Ended December 31,				
<i>(in thousands except per share data and ratios)</i>	2011	2010	2009	2008	2007
<u>Summary of Year-to-Date Earnings:</u>					
Interest income and loan fees	\$27,940	\$32,490	\$35,676	\$45,147	\$57,156
Interest expense	2,964	4,589	7,327	14,938	20,573
Net interest income	24,976	27,901	28,349	30,209	36,583
Provision for credit losses	13,602	12,475	13,375	9,526	6,231
Net interest income after Provision for credit losses	11,374	15,426	14,974	20,683	30,372
Noninterest income	6,877	5,939	6,305	8,343	9,681
Noninterest expense	30,778	29,020	27,966	23,351	22,215
(Loss) income before taxes on income	(12,527)	(7,655)	(6,687)	5,675	17,818
Taxes on income	(1,715)	(3,216)	(2,150)	1,605	6,561
Net (loss) income	(\$10,812)	(\$4,439)	(\$4,537)	\$4,070	\$11,257
<u>Per Share Data:</u>					
Net (loss) income – Basic	(\$0.80)	(\$0.34)	(\$0.35)	\$0.31	\$0.85
Net (loss) income – Diluted	(\$0.80)	(\$0.34)	(\$0.35)	\$0.31	\$0.85
Average shares outstanding – Basic	13,531,832	13,003,840	13,003,840	13,047,046	13,173,466
Average shares outstanding - Diluted	13,531,832	13,003,840	13,003,840	13,050,752	13,211,849
Cash dividends paid	\$0.00	\$0.00	\$0.00	\$0.26	\$0.50
<u>Financial Position at Period-end:</u>					
Total assets	\$651,332	\$678,210	\$693,235	\$761,077	\$771,715
Total net loans and leases	394,498	424,526	492,692	531,788	583,625
Total deposits	574,427	557,466	561,660	508,486	634,617
Total shareholders' equity	62,173	73,270	75,821	79,610	82,431
Book value per share	\$4.59	\$5.63	\$6.07	\$6.37	\$6.55
<u>Selected Financial Ratios:</u>					
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%
Allowance for credit losses as a percentage of total nonperforming loans	45.52%	35.19%	29.57%	25.24%	45.99%
Net charge-offs to average loans	3.88%	2.24%	1.85%	0.93%	0.77%
Allowance for credit losses as a percentage of period-end loans	3.34%	3.75%	2.96%	2.12%	1.26%
Dividend payout ratio	0.00%	0.00%	80.12%	80.12%	56.39%

*To Our Faithful
Shareholders, Customers and Friends,*

Real estate price declines that began four years ago showed signs of stabilization as 2011 ended and 2012 began. From Merced to Kern County (as well as other regions of the USA), residential real estate prices showed modest increases or modest declines as 2011 ended and 2012 began.

While it is premature to proclaim the end of real estate price declines, the recent data is painting the best picture seen in our market in four years. We all want to know whether recent trends are sustainable but for now, the answer is unknowable.

What is known is that the price declines of the past four years were severe in aggregate and precipitated write-downs on: OREO property values; values of securities; carrying values of goodwill; and higher legal, regulatory assessments and provisions for loan loss expense. These increased costs were the primary causes for the losses reported over the last three years.

For 2011, the reported loss of \$10.8 million included a \$3.7 million expense associated with a valuation of deferred tax assets (DTA). The expense represents 34% of the reported loss of \$10.8 million. Absent the adjustment for the DTA valuation allowance, the net loss was \$7.1 million.

Without being too technical, (DTA's) are differences between Generally Accepted Accounting Principle (GAAP) books and tax books. Some expenses for GAAP are not deductible for tax until later (deferred). For examples the provision for loan losses or write-downs on OREO are deducted from revenue when recorded under GAAP but cannot be deducted on tax books until the loan is charged-off or the property is sold. GAAP requires a valuation of the deferred tax assets to ensure the DTA's are more likely than not, realizable. GAAP is more restrictive when three-consecutive annual losses occur.

In future years, the Company's actual taxable income and projected taxable income will be utilized to determine the appropriate valuation allowance level. If the level is too high, income will increase as the valuation allowance is lowered or conversely, if the valuation level is too low, net income will decrease as the valuation allowance is increased.

Core Earnings

Core earnings are defined as net interest income plus noninterest income less "normalized" noninterest expense and provision for loan loss. As mentioned above, the provision for loan loss and expenses associated with OREO, real estate secured securities, and most legal expense are directly related to real estate prices. When real estate prices are falling, these expenses increase.

Also related but less directly are regulatory assessments, also know as, FDIC insurance premiums. As real estate prices declined around the county more banks failed as higher costs eroded capital. The FDIC remedies failures by spending insurance premium dollars. In order to reload their dwindling funds, FDIC increased premiums to banks ten-fold.

If real estate prices stabilize, expense will “normalize” and a return to profitability will ensue. If real estate prices resume their decline, profitability or lack thereof will be directly related to the severity of any overall decline in real estate prices.

There are a number of arguments that point to price stabilization.

- *After four years of decline, prices are generally below the cost of manufacture.*
- *The population growth in the Central Valley continues to outpace most other regions of the state. The number of persons per household is increasing over the past several years in the Central Valley.*
- *Generation Y, those between 14 and 32 years old, number 80 million. This group has been reluctant to purchase a home or move to an apartment when they became “of age” and instead in large part chose to remain “at home” with parents. Signs are emerging this group is beginning to buy homes.*
- *If the construction of the high-speed rail begins in the Central Valley later this year, employees of the project will relocate here and jobs for some living here will increase. Both factors will increase demand for housing.*

There are a number of arguments that point to a resumption of price decline.

- *The “robo-signing” debacle delayed foreclosures and as it is resolved foreclosures will resume and exert downward pressure on price.*
- *Loan modification programs designed to help distressed homeowners keep their homes may not be effective.*
- *There is a backlog of foreclosures estimated between 1.8 million to 2.5 million that have been delayed for any of several reasons.*

To summarize, the Bank’s core earnings are sufficient to generate profits given real estate price stabilization. Evidence of real estate price stabilization is present. Speculation about the future of real estate prices abound but the outcome is not yet knowable.

On the Horizon:

Even though the economic recovery is slow, the Company is benefiting from business development efforts to increase core deposits and reduce wholesale funding. Loan demand is increasing. With the first quarter just behind us, the evidence of a profitable year is present as we wait to learn if real estate prices continue to stabilize.

Our longstanding presence in our markets and our dedicated management team, along with an experienced and competent staff, are the keys to the Company’s long-term success. We continue to take pride in our premier customer service and vision to grow the franchise in existing and new markets.

Thank you again for your support and loyalty, you are key to our long-term success.

Sincerely,



Dennis R. Woods
Chairman of the Board & President



Ronnie D. Miller
Lead Director

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

	December 31,	
	2011	2010
<i>(in thousands except shares)</i>		
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

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

<i>(in thousands except shares and EPS)</i>	2011	2010
Interest Income		
Loans, including fees	\$25,573	\$29,502
Investment securities - AFS – taxable	2,141	2,794
Investment securities - AFS – nontaxable	0	58
Federal funds sold and securities purchased under agreements to resell	1	36
Interest on deposits in FRB	186	59
Interest on deposits in other banks	39	41
Total interest income	27,940	32,490
Interest Expense		
Interest on deposits	2,620	4,217
Interest on other borrowed funds	344	372
Total interest expense	2,964	4,589
Net Interest Income Before Provision for Credit Losses	24,976	27,901
Provision for Credit Losses	13,602	12,475
Net Interest Income	11,374	15,426
Noninterest Income		
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
Noninterest Expense		
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 comprehensive loss, pre-tax)	912	1,253
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

Comprehensive (Loss) Income**Net (Loss) Income per common share**

Basic

Diluted

**Weighted shares on which net (loss) income per common
share were based**

Basic

Diluted

See notes to consolidated financial statements

	(303)	1,847
	<u>\$(11,115)</u>	<u>\$(2,592)</u>
	(\$0.80)	(\$0.33)
	<u>(\$0.80)</u>	<u>(\$0.33)</u>
	13,531,832	13,531,832
	<u>13,531,832</u>	<u>13,531,832</u>

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

<i>(in thousands except shares)</i>	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)		0
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

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	9,603
Cash Flows From Investing Activities:		
Net (increase) decrease in interest-bearing deposits with banks	2,209	(1,083)
Purchases of available-for-sale securities	(8,500)	(10,160)
Net redemption (purchase) of FHLB/FRB and other bank stock	600	307
Maturities, calls, and principal payments on available-for-sale securities	18,840	14,887
Proceeds from sales of available-for-sale securities	2,000	17,060
(Investment in) distribution from limited partnership	0	(1,577)
Investment in bank stock	12	0
Proceeds from life insurance settlement	0	1,020
Proceeds from sales of loans	0	17,640
Net decrease in loans	14,446	26,732
Cash proceeds from sales of other real estate owned	6,458	7,660
Cash proceeds from sales of premises and equipment	0	22
Capital expenditures for premises and equipment	(914)	(791)
Purchase of bank owned life insurance	(125)	0
Net cash provided by (used in) investing activities	35,026	71,717
Cash Flows From Financing Activities:		
Net increase (decrease) in demand deposit and savings accounts	73,014	25,263
Net (decrease) increase in certificates of deposit	(56,053)	(29,457)
Net (decrease) increase in federal funds purchased	0	0
Net (decrease) increase in FHLB borrowings	(32,000)	(8,000)
Proceeds from note payable	0	75
Net cash used in financing activities	(15,039)	(12,119)
Net increase (decrease) in cash and cash equivalents	24,755	69,201
Cash and cash equivalents at beginning of year	98,430	29,229
Cash and cash equivalents at end of year	\$124,185	\$98,430

See notes to consolidated statements

Notes to Consolidated Financial Statements
Years Ended December 31, 2011 and 2010

1. Organization and Summary of Significant Accounting and Reporting Policies

Basis of Presentation – The consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States and with prevailing practices within the banking industries. The consolidated financial statements include the accounts of United Security Bancshares, and its wholly owned subsidiary, United Security Bank and subsidiary (the “Bank”). United Security Bancshares Capital Trust II (the “Trust”) is deconsolidated pursuant to ASC 810. As a result, the Trust Preferred Securities are not presented on the Company’s consolidated financial statements as equity, but instead the Company’s Subordinated Debentures are presented as a separate liability category. (see Note 8 to the Company’s consolidated financial statements). Intercompany accounts and transactions have been eliminated in consolidation. In the following notes, references to the Bank are references to United Security Bank. References to the Company are references to United Security Bancshares, (including the Bank). United Security Bancshares operates as one business segment providing banking services to commercial establishments and individuals primarily in the San Joaquin Valley of California.

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

During July 2007 the Company formed 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. (See Note 8. “Junior Subordinated Debt/Trust Preferred Securities”).

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

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

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

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

Use of Estimates in the Preparation of Financial Statements - The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of

contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.

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

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

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

a. *Cash and cash equivalents* – Cash and cash equivalents include cash on hand, amounts due from banks, federal funds sold and repurchase agreements. At times throughout the year, balances can exceed FDIC insurance limits. Generally, federal funds sold and repurchase agreements are sold for one-day periods. The Bank did not have any repurchase agreements during 2011 or 2010, or at December 31, 2011 or 2010. All cash and cash equivalents have maturities when purchased of three months or less.

b. *Securities* - Debt and equity securities classified as available for sale are reported at fair value, with unrealized gains and losses excluded from net income and reported, net of tax, as a separate component of comprehensive income and shareholders’ equity. Debt securities classified as held to maturity are carried at amortized cost. Gains and losses on disposition are reported using the specific identification method for the adjusted basis of the securities sold. Premiums and discounts are recognized in interest income using the interest method over the period to maturity.

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

Investments with fair values that are less than amortized cost are considered impaired. Impairment may result from either a decline in the financial condition of the issuing entity or, in the case of fixed interest rate investments, from rising interest rates. At each financial statement date, management assesses each investment to determine if impaired investments are temporarily impaired or if the impairment is other-than-temporary based upon the positive and negative evidence available. Evidence evaluated includes, but is not limited to, industry analyst reports, credit market conditions, and interest rate trends. If negative evidence outweighs positive evidence that the carrying amount is recoverable within a reasonable period of time, the impairment is deemed to be other-than-temporary and the debt security is written down by the amount related to credit losses in the period in which such determination is made, or written down to fair value if the debt security is more than likely to be sold.

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

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

of credit fees, loan placement fees and annual credit card fees are recognized as noninterest income during the period the related service is performed.

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

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

Specific allowances are established based on management's periodic evaluation of loss exposure inherent in impaired loans.

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

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

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

Buildings	31 Years	Furniture and equipment	3-7 Years
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- f. *Other Real Estate Owned* - Real estate properties acquired through, or in lieu of, loan foreclosure are to be sold and are initially recorded at fair value of the property, less estimated costs to sell. The excess, if any, of the loan amount over the fair value is charged to the allowance for credit losses. Subsequent declines in the

fair value of other real estate owned, along with related revenue and expenses from operations, are charged to noninterest expense.

- g. *Intangible Assets and Goodwill* - Intangible assets are comprised of core deposit intangibles, other specific identifiable intangibles, and goodwill acquired in branch acquisitions where the consideration given exceeded the fair value of the net assets acquired. Intangible assets and goodwill are reviewed at least annually for impairment. Core deposit intangibles of \$448,000 and \$966,000 (net of accumulated amortization and impairment losses of \$6,549,000 and \$6,031,000) at December 31, 2011 and 2010, respectively, are amortized over the estimated useful lives of the existing deposit bases (average of 7 years) using a method which approximates the interest method. Other specific identifiable intangibles resulting from the purchase of certain bank branches in 1997, which were non-self-sustaining businesses, of \$106,000 and \$244,000 (net accumulated amortization of \$1.9 million and \$1.8 million) at December 31, 2011 and 2010, respectively, are being amortized using a method which approximates the interest method over a period of 15 years. During 2011 and 2010, the Company recognized impairment losses of \$36,000 and \$57,000, respectively, on the core deposit intangible related to the deposits purchased in the Legacy merger consummated during February 2007.

The estimated aggregate amortization expense related to intangible assets for each of the five succeeding years is as follows (in 000's):

Year	Amortization expense
2012	554
2013	0
2014	0
2015	0
2016	0
Total	\$554

Goodwill amounts resulting from the acquisitions of Taft National Bank during April 2004, and Legacy Bank during February 2007 are considered to have an indefinite life and are not amortized. At December 31, 2011, goodwill related to Taft National Bank totaled \$1.6 million, and goodwill related to Legacy Bank totaled \$2.8 million. Impairment testing of goodwill is performed at the reporting level during April of each year for Taft, and during March of each year for Legacy. During 2011 and 2010, the Company recognized pre-tax and after-tax impairment adjustments of \$1,489,000 and \$1,414,000, respectively, on the goodwill related to the Legacy Bank merger (see Note 21 to the Company's consolidated financial statements contained herein for details of the goodwill impairment.)

- h. *Income Taxes* - Deferred income taxes are provided for the temporary differences between the financial reporting basis and the tax basis of the Company's assets and liabilities using the liability method, and are reflected at currently enacted income tax rates applicable to the period in which the deferred tax assets or liabilities are expected to be realized or settled.
- i. *Net (Loss) Income per Share* - Basic (loss) income per common share is computed based on the weighted average number of common shares outstanding. Diluted (loss) income per share includes the effect of stock options and other potentially dilutive securities using the treasury stock method to the extent they have a dilutive impact. Net (loss) income per share date has been retroactively adjusted for all stock dividends declared.
- j. *Cash Flow Reporting* - For purposes of reporting cash flows, cash and cash equivalents include cash on hand, noninterest-bearing amounts due from banks, federal funds sold and securities purchased under agreements to resell. Federal funds and securities purchased under agreements to resell are generally sold for one-day periods.
- k. *Transfers of Financial Assets* - Transfers of financial assets are accounted for as sales when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when (1) the assets have been isolated from the Company, (2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and (3) the Company does

not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.

- l. *Advertising Costs* - The Company expenses marketing costs as they are incurred. Advertising expense was \$60,000 and \$73,000 for the years ended December 31, 2011, and 2010, respectively.
- m. *Stock Based Compensation* - The Company has a stock-based employee compensation plan, which is described more fully in Note 10. The Company accounts for all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements based on the grant-date fair value of the award. The fair value is amortized over the requisite service period (generally the vesting period). Included in salaries and employee benefits for the years ended December 31, 2011, and 2010 is \$18,000, and \$42,000, respectively, of share-based compensation. The related tax benefit, recorded in the provision for income taxes, was not significant.
- n. *Federal Home Loan Bank stock and Federal Reserve Stock* - As a member of the Federal Home Loan Bank (FHLB), the Company is required to maintain an investment in capital stock of the FHLB. In addition, as a member of the Federal Reserve Bank (FRB), the Company is required to maintain an investment in capital stock of the FRB. The investments in both the FHLB and the FRB are carried at cost, which approximates their fair value, in the accompanying consolidated balance sheets under other assets and are subject to certain redemption requirements by the FHLB and FRB. Stock redemptions are at the discretion of the FHLB and FRB.

While technically these are considered equity securities, there is no market for the FHLB or FRB stock. Therefore, the shares are considered as restricted investment securities. Management periodically evaluates the stock for other-than-temporary impairment. Management's determination of whether these investments are impaired is based on its assessment of the ultimate recoverability of cost rather than by recognizing temporary declines in value. The determination of whether a decline affects the ultimate recoverability of cost is influenced by criteria such as (1) the significance of any decline in net assets of the FHLB or FRB as compared to the capital stock amount of the FHLB or FRB and the length of time this situation has persisted, (2) commitments by the FHLB or FRB to make payments required by law or regulation and the level of such payments in relation to the operating performance of the FHLB or FRB, (3) the impact of legislative and regulatory changes on institutions and, accordingly, the customer base of the FHLB or FRB, and (4) the liquidity position of the FHLB or FRB.
- o. *Comprehensive (Loss) Income* -Comprehensive (loss) income is comprised of net income and other comprehensive (loss) income. Other comprehensive (loss) income includes items recorded directly to equity, such as unrealized gains and losses on securities available-for-sale, unrecognized costs of salary continuation defined benefit plans. Comprehensive (loss) income is presented in the consolidated statement of Operations and Comprehensive (Loss) Income.
- p. *Segment Reporting* - The Company's operations are solely in the financial services industry and include providing to its customers traditional banking and other financial services. The Company operates primarily in the San Joaquin Valley region of California. Management makes operating decisions and assesses performance based on an ongoing review of the Company's consolidated financial results. Therefore, the Company has a single operating segment for financial reporting purposes.
- q. *Stock based transactions* – All share data contained within the financial statements has been retroactively restated for stock based transactions (i.e. stock splits and stock dividends.)
- r. *New Accounting Standards:*

In January 2010, the FASB issued ASU No. 2010-06, *Fair Value Measurements and Disclosures (Topic 820)—Improving Disclosures about Fair Value Measurements*. FASB ASU No. 2010-06 requires (i) fair value disclosures by each class of assets and liabilities (generally a subset within a line item as presented in the statement of financial position) rather than major category, (ii) for items measured at fair value on a recurring basis, the amounts of significant transfers between Levels 1 and 2, and transfers into and out of Level 3, and the reasons for those transfers, including separate discussion related to the transfers into each level apart from transfers out of each level, and (iii) gross presentation of the amounts of purchases, sales, issuances, and settlements in the Level 3 recurring measurement reconciliation. Additionally, the ASU clarifies that a

description of the valuation techniques(s) and inputs used to measure fair values is required for both recurring and nonrecurring fair value measurements. Also, if a valuation technique has changed, entities should disclose that change and the reason for the change. Disclosures other than the gross presentation changes in the Level 3 reconciliation are effective for the first reporting period beginning after December 15, 2009. The requirement to present the Level 3 activity of purchases, sales, issuances, and settlements on a gross basis will be effective for fiscal years beginning after December 15, 2010. This update became effective for the Company in the quarter beginning January 1, 2010, except that the disclosure on the roll forward activities for Level 3 fair value measurements which will become effective with the reporting period beginning January 1, 2011. Other than requiring additional disclosures, adoption of this new guidance did not have a material impact on the Company's financial statements.

In July 2010, the FASB issued ASU 2010-20, "Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses." The new disclosure guidance significantly expands the existing requirements and will lead to greater transparency into a company's exposure to credit losses from lending arrangements. The extensive new disclosures of information as of the end of a reporting period will become effective for both interim and annual reporting periods ending on or after December 15, 2010. Specific disclosures regarding activity that occurred before the issuance of the ASU, such as the allowance roll forward and modification disclosures will be required for periods beginning on or after December 15, 2010. The Company has included the required disclosures in its consolidated financial statements.

In September 2011, the FASB issued ASU 2011-08, Intangibles - Goodwill and Other (Topic 350) - Testing Goodwill for Impairment. ASU 2011-08 amends Topic 350, Intangibles – Goodwill and Other, to give entities the option to first assess qualitative factors to determine whether the existence of events or circumstances leads to a determination that it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If, after assessing the totality of events or circumstances, an entity determines it is not more likely than not that the fair value of a reporting unit is less than its carrying amount, then performing the two-step impairment test is unnecessary. However, if an entity concludes otherwise, then it is required to perform the first step of the two-step impairment test by calculating the fair value of the reporting unit and comparing the fair value with the carrying amount of the reporting unit. ASU 2011-08 was effective for annual and interim impairment tests beginning after December 15, 2011. The adoption of the new guidance did not have a significant impact on the Company's financial statements.

In April 2011, the FASB issued ASU No. 2011-02, Receivables (Topic 310): A Creditor's Determination of Whether a Restructuring Is a Troubled Debt Restructuring. ASU 2011-02 clarifies the guidance in ASC 310-40 Receivables: Troubled Debt Restructurings by Creditors. Creditors are required to identify a restructuring as a troubled debt restructuring if the restructuring constitutes a concession and the debtor is experiencing financial difficulties. ASU 2011-02 clarifies guidance on whether a creditor has granted a concession and clarifies the guidance on a creditor's evaluation of whether a debtor is experiencing financial difficulties. In addition, ASU 2011-02 also precludes the creditor from using the effective interest rate test in the debtor's guidance on restructuring of payables when evaluating whether a restructuring constitutes a troubled debt restructuring. The effective date of ASU 2011-2 for public entities is effective for the first interim or annual period beginning on or after June 15, 2011, and should be applied retrospectively to the beginning of the annual period of adoption. If, as a result of adoption, an entity identifies newly impaired receivables, an entity should apply the amendments for purposes of measuring impairment prospectively for the first interim or annual period beginning on or after June 15, 2011. The Company adopted the methodologies prescribed by this ASU during the third quarter 2011 and did not have a material effect on its financial statements.

In April 2011, the FASB issued ASU 2011-03, Reconsideration of Effective Control for Repurchase Agreements. This ASU was developed to improve the accounting for repurchase agreements (repos) and other agreements that both entitle and obligate a transferor to repurchase or redeem financial assets before their maturity. The amendments in this ASU remove from the assessment of effective control (1) the criterion requiring the transferor to have the ability to repurchase or redeem the financial assets on substantially the agreed terms, even in the event of default by the transferee, and (2) the collateral maintenance implementation guidance related to that criterion. The amendments in this ASU apply to all entities, both public and nonpublic. The amendments affect all entities that enter into agreements to transfer financial assets that both entitle and obligate the transferor to repurchase or redeem the financial assets before their maturity. The guidance in this ASU was effective for the first interim or annual period beginning on or after December 15, 2011 and should be applied prospectively to transactions or modifications of existing transactions that occur on or after the effective date. Early adoption is not permitted. This ASU is not expected to have a significant impact on the Company's financial statements.

In May 2011, the FASB issued ASU 2011-04, Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs. The amendments in this ASU result in common fair value measurement and disclosure requirements in U.S. GAAP and IFRSs. Consequently, the amendments change the wording used to describe many of the requirements in U.S. GAAP for measuring fair value and for disclosing information about fair value measurements. The amendments in this ASU are to be applied prospectively. For public entities, the amendments are effective during interim and annual periods beginning after December 15, 2011. Early application by public entities is not permitted. This ASU is not expected to have a significant impact on the Company's financial statements.

In June 2011, the FASB issued ASU No. 2011-05, Presentation of Comprehensive Income. ASU 2011-05 requires entities to present the total of comprehensive income, the components of net income and the components of other comprehensive income in a single continuous statement of comprehensive income or in two separate consecutive statements. The effective date for ASU 2011-05 is for the first interim or annual period beginning on or after December 15, 2011. The adoption of ASU 2011-05 is not expected to have a material impact on the Company's results of operations or financial position. It will present a change in disclosure as the Company currently presents comprehensive income in its consolidated statement of changes in shareholders' equity.

- s. *Reclassifications* - Certain reclassifications have been made to the 2010 financial statements to conform to the classifications used in 2011. None of the reclassifications had an impact on equity or net (loss) income.

2. Investment Securities

Following is a comparison of the amortized cost and approximate fair value of investment securities at December 31, 2011 and December 31, 2010:

<i>(In thousands)</i>	Amortized	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value (Carrying Amount)
<u>December 31, 2011:</u>				
<u>Securities available for sale:</u>				
U.S. Government agencies	\$23,680	\$1,377	(\$7)	\$25,050
U.S. Government collateralized mortgage obligations	5,010	425	0	5,435
Residential mortgage obligations	10,238	0	(2,265)	7,973
Total securities available for sale	<u>\$38,928</u>	<u>\$1,802</u>	<u>(\$2,272)</u>	<u>\$38,458</u>
<u>December 31, 2010:</u>				
<u>Securities available for sale:</u>				
U.S. Government agencies	\$32,486	\$1,303	(\$1)	\$33,788
U.S. Government collateralized mortgage obligations	7,203	552	0	7,755
Residential mortgage obligations	11,955	0	(1,995)	9,960
Total securities available for sale	<u>\$51,644</u>	<u>\$1,855</u>	<u>\$(1,996)</u>	<u>\$51,503</u>

There were gross realized gains on available-for-sale securities totaling \$11,000, but there were no gross losses during the year ended December 31, 2011. There were gross realized gains on sales of available-for-sale securities totaling \$522,000 and gross realized losses totaling \$454,000 during the year ended December 31, 2010.

The amortized cost and fair value of securities available for sale at December 31, 2011, by contractual maturity, are shown below. Actual maturities may differ from contractual maturities because issuers have the right to call or prepay obligations with or without call or prepayment penalties. Contractual maturities on collateralized mortgage obligations cannot be anticipated due to allowed paydowns.

<i>(In thousands)</i>	December 31, 2011	
	Amortized Cost	Fair Value (Carrying Amount)
Due in one year or less	\$1,500	\$1,515
Due after one year through five years	8,034	8,133
Due after five years through ten years	4,323	4,641
Due after ten years	9,823	10,762
Collateralized mortgage obligations	15,246	13,407
	<u>\$38,928</u>	<u>\$38,458</u>

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

The Company had no held-to-maturity or trading securities at December 31, 2011 or 2010.

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

The following summarizes temporarily impaired investment securities at December 31, 2011 and 2010:

<i>(In thousands)</i>	Less than 12 Months		12 Months or More		Total	
	Fair Value (Carrying Amount)	Unrealized Losses	Fair Value (Carrying Amount)	Unrealized Losses	Fair Value (Carrying Amount)	Unrealized Losses
<u>December 31, 2011:</u>						
<u>Securities available for sale:</u>						
U.S. Government agencies	\$2,143	(\$7)	\$0	\$0	\$2,143	(\$7)
U.S. Government agency collateral mortgage obligations	0	0	0	0	0	0
Residential mortgage obligations	0	0	7,994	(2,265)	7,994	(2,265)
Total impaired securities	<u>\$2,143</u>	<u>(\$7)</u>	<u>\$7,994</u>	<u>(\$2,265)</u>	<u>\$10,137</u>	<u>(\$2,272)</u>
<u>December 31, 2010:</u>						
<u>Securities available for sale:</u>						
U.S. Government agencies	\$135	(\$1)	\$0	\$0	\$135	(\$1)
U.S. Government agency collateral mortgage obligations	0	0	0	0	0	0
Residential mortgage obligations	0	0	9,960	(1,995)	9,960	(1,995)
Total impaired securities	<u>\$135</u>	<u>(\$1)</u>	<u>\$9,960</u>	<u>(\$1,995)</u>	<u>\$10,095</u>	<u>(\$1,996)</u>

Temporarily impaired securities at December 31, 2011 are comprised of three (3) residential mortgage obligations, and two (2) U.S. government agency securities, with a total weighted average life of 2.9 years. Temporarily impaired securities at December 31, 2010 are comprised of three (3) residential mortgage obligations, and one (1) U.S. government agency securities, with a total weighted average life of 3.9 years.

The Company evaluates investment securities for other-than-temporary impairment (“OTTI”) at least quarterly, and more frequently when economic or market conditions warrant such an evaluation. The investment securities portfolio is evaluated for OTTI by segregating the portfolio into two general segments and applying the appropriate OTTI model. Investment securities of high credit quality are generally evaluated for OTTI under ASC Topic 320-10, “*Investments – Debt and Equity Instruments.*” Certain purchased beneficial interests not of high credit quality, including non-agency mortgage-backed securities, asset-backed securities, and collateralized debt obligations, are evaluated using the model outlined in ASC Topic 320-40.

For the segment of the portfolio using ASC Topic 320-40 in determining OTTI, the Company considers many factors, including: (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, (3) whether the market decline was affected by macroeconomic conditions, and (4) whether the entity has the intent to sell the debt security or more likely than

not will be required to sell the debt security before its anticipated recovery. The assessment of whether an other-than-temporary decline exists involves a high degree of subjectivity and judgment and is based on the information available to the Company at the time of the evaluation.

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

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

At December 31, 2011, the decline in fair value for all but three (see below) of the impaired securities is attributable to changes in interest rates and illiquidity, and not credit quality. Because the Company does not have the intent to sell these impaired securities and it is likely that it will not be required to sell the securities before their anticipated recovery, the Company does not consider these securities to be other-than-temporarily impaired at December 31, 2011.

At December 31, 2011, the Company had three non-agency residential mortgage obligations which have been impaired more than twelve months. The three non-agency residential mortgage obligations had a fair value of \$8.0 million and unrealized losses of approximately \$2.3 million at December 31, 2011. All three non-agency mortgage-backed securities were rated below investment grade quality at December 31, 2011. The Company evaluated these three non-agency residential mortgage obligations quarterly for OTTI by comparing the present value of expected cash flows to previous estimates to determine whether there had been adverse changes in cash flows during the year. The OTTI evaluation was conducted utilizing the services of a third party specialist and consultant in MBS and CMO products. The cash flow assumptions used in the evaluation included a number of factors including changes in delinquency rates, anticipated prepayment speeds, loan-to-value ratios, changes in agency ratings, and market prices. As a result of the impairment evaluation, the Company determined that there had been adverse changes in cash flows during the year for all three of the non-agency residential mortgage obligations reviewed, and concluded that these three non-agency residential mortgage obligations were other-than-temporarily impaired. At December 31, 2011, the three securities had other-than-temporary-impairment losses of \$4.5 million, of which \$2.2 million was recorded as a charge to earnings (\$912,000 for the year ended December 31, 2011) and \$2.3 million was recorded in other comprehensive loss. These three non-agency residential mortgage obligations remained classified as available for sale at December 31, 2011.

The following table details the three non-agency residential mortgage obligations with other-than-temporary-impairment, their credit rating at December 31, 2011, the related credit losses recognized in earnings for the year ended, and impairment losses included in other comprehensive loss.

<i>December 31, 2011 (in 000's)</i>	RALI 2006-QS1G	RALI 2006 QS8	CWALT 2007-	Total
	A10	A1	8CB A9	
	Rated D	Rated D	Rated CCC	
Amortized cost – before OTTI	\$4,006	\$1,227	\$7,262	\$12,495
Credit loss	(831)	(236)	(1,190)	(2,257)
Other impairment (OCI)	(789)	(264)	(1,212)	(2,265)
Carrying amount – December 31, 2011	\$2,386	\$727	\$4,828	\$7,972
Total impairment - December 31, 2011	(\$1,620)	(\$501)	(\$2,402)	(\$4,522)

The total other comprehensive loss (OCI) balance of \$2.3 million in the above table is included in unrealized losses of 12 months or more at December 31, 2011.

The following table details the three non-agency residential collateralized mortgage obligations with other-than-temporary-impairment, their credit rating at December 31, 2010, the related credit losses recognized in earnings for the year ended, and impairment losses included in other comprehensive loss.

<i>December 31, 2010 (000's)</i>	RALI 2006-QS1G	RALI 2006 QS8	CWALT 2007-	Total
	A10	A1	8CB A9	
	Rated CCC	Rated CCC	Rated CCC	
Amortized cost – before OTTI	\$4,897	\$1,491	\$7,663	\$14,051
Credit loss – year ended December 31, 2010	(1,338)	(404)	(354)	(2,096)
Other impairment (OCI)	(455)	(140)	(1,400)	(1,995)
Carrying amount – December 31, 2010	\$3,104	\$947	\$5,909	\$9,960
Total impairment - YTD December 31, 2010	(\$1,793)	(\$544)	(\$1,754)	(\$4,091)

The total other comprehensive loss (OCI) balance of \$2.0 million in the above table is included in unrealized losses of 12 months or more at December 31, 2010.

3. Loans

Loans are comprised of the following:

<i>(In thousands)</i>	December 31, 2011	December 31, 2010
Commercial and business loans	\$163,442	\$154,624
Government program loans	2,984	4,600
Total commercial and industrial	\$166,426	\$159,224
Real estate – mortgage:		
Commercial real estate	118,857	131,632
Residential mortgages	24,031	23,764
Home Improvement and Home Equity loans	1,859	2,385
Total real estate mortgage	144,747	157,781
RE construction and development	50,400	65,182
Agricultural	35,811	46,308
Installment	11,282	12,891
Lease financing	49	305
Total Loans	\$408,715	\$441,691

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

Commercial and industrial loans represent 40.7% of total loans at December 31, 2011 and are generally made to support the ongoing operations of small-to-medium sized commercial businesses. Commercial and industrial loans have a high degree of industry diversification and provide, working capital, financing for the purchase of manufacturing plants and equipment, or funding for growth and general expansion of businesses. A substantial portion of commercial and industrial loans are secured by accounts receivable, inventory, leases or other collateral including real estate. The remainder are unsecured; however, extensions of credit are predicated upon the financial capacity of the borrower. Repayment of commercial loans is generally from the cash flow of the borrower.

Real estate mortgage loans, representing 35.4% of total loans at December 31, 2011, are secured by trust deeds on primarily commercial property, but are also secured by trust deeds on single family residences. Repayment of real estate mortgage loans is generally from the cash flow of the borrower.

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

Real estate construction and development loans, representing 12.3% of total loans at December 31, 2011, consist of loans for residential and commercial construction projects, as well as land acquisition and development, or land held for future development. Loans in this category are secured by real estate including improved and unimproved land, as well as single-family residential, multi-family residential, and commercial properties in various stages of completion. All real estate loans have established equity requirements. Repayment on construction loans is generally from long-term mortgages with other lending institutions obtained at completion of the project.

Agricultural loans represent 8.8% of total loans at December 31, 2011 and are generally secured by land, equipment, inventory and receivables. Repayment is from the cash flow of the borrower.

In the normal course of business, the Company is party to financial instruments with off-balance sheet risk to meet the financing needs of its customers. At December 31, 2011 and 2010, these financial instruments include commitments to extend credit of \$62.4 million and \$67.8 million, respectively, and standby letters of credit of \$2.5 million and \$1.8 million, respectively. These instruments involve elements of credit risk in excess of the amount recognized on the balance sheet. The contract amounts of these instruments reflect the extent of the involvement the Company has in off-balance sheet financial instruments.

Occasionally, shared appreciation agreements are made between the Company and the borrower on certain construction loans where the Company agrees to receive interest on the loan at maturity rather than monthly and the borrower agrees to share in the profits of the project. Due to the difficulty in calculating future values, shared appreciation income is recognized when received. The Company does not participate in a significant number of

shared appreciation projects. The Company received no shared appreciation income during the years ended December 31, 2011 and 2010.

The Company has, and expects to have, lending transactions in the ordinary course of its business with directors, officers, principal shareholders and their affiliates. These loans are granted on substantially the same terms, including interest rates and collateral, as those prevailing on comparable transactions with unrelated parties, and do not involve more than the normal risk of collectibility or present unfavorable features.

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

<i>(In thousands)</i>	December 31,	
	2011	2010
Aggregate amount outstanding, beginning of year	10,580	9,146
New loans or advances during year	1,959	5,783
Repayments during year	(9,295)	(4,349)
Aggregate amount outstanding, end of year	\$3,244	\$10,580
Loan commitments	\$3,001	\$4,030

Past Due Loans

The Company monitors delinquency and potential problem loans on an ongoing basis through weekly reports to the Loan Committee and monthly reports to the Board of Directors. Loans over 90 days past due and still accruing totaled \$74,000 and \$547,000 at December 31, 2011 and December 31, 2010, respectively. The following is a summary of delinquent loans at December 31, 2011:

December 31, 2011 (000's)	Loans 30-60 Days Past Due	Loans 61-89 Days Past Due	Loans 90 or More Days Past Due	Total Past Due Loans	Current Loans	Total Loans	Accruing Loans 90 or More Days Past Due
Commercial and Business Loans	154	191	3,552	3,897	159,545	\$163,442	0
Government Program Loans	0	0	433	433	2,551	2,984	74
Total Commercial and Industrial	154	191	3,985	4,330	162,096	166,426	74
Commercial Real Estate Loans	1,248	2,514	0	3,762	115,095	118,857	0
Residential Mortgages	328	0	0	328	23,703	24,031	0
Home Improvement and Home Equity Loans	62	132	0	194	1,665	1,859	0
Total Real Estate Mortgage	1,638	2,646	0	4,284	140,463	144,747	0
Total RE Construction and Development Loans	0	0	6,150	6,150	44,250	50,400	0
Total Agricultural Loans	0	0	0	0	35,811	35,811	0
Consumer Loans	297	0	0	297	10,776	11,073	0
Overdraft protection Lines	0	0	0	0	85	85	0
Overdrafts	0	0	0	0	124	124	0
Total Installment	297	0	0	297	10,985	11,282	0
Lease Financing	0	0	0	0	49	49	0
Total Loans	2,089	2,837	10,135	15,061	393,654	\$408,715	74

The following is a summary of delinquent loans at December 31, 2010:

December 31, 2010 (000's)	Loans 30-60 Days Past Due	Loans 61-89 Days Past Due	Loans 90 or More Days Past Due	Total Past Due Loans	Current Loans	Total Loans	Accruing Loans 90 or More Days Past Due
Commercial and Business Loans	\$4,554	\$443	\$4,637	\$9,634	\$144,990	\$154,624	\$454
Government Program Loans	114	106	305	525	4,075	4,600	93
Total Commercial and Industrial	4,668	549	4,942	10,159	149,065	159,224	547
Commercial Real Estate Loans	0	0	1,405	1,405	130,227	131,632	0
Residential Mortgages	0	328	98	426	23,338	23,764	0
Home Improvement and Home Equity Loans	102	55	45	202	2,183	2,385	0
Total Real Estate Mortgage	102	383	1,548	2,033	155,748	157,781	0
Total RE Construction and Development Loans	4,004	3,395	1,630	9,029	56,153	65,182	0
Total Agricultural Loans	0	0	398	398	45,910	46,308	0
Consumer Loans	39	12	57	108	12,354	12,462	0
Overdraft protection Lines	0	0	0	0	74	74	0
Overdrafts	0	0	0	0	355	355	0
Total Installment	39	12	57	108	12,783	12,891	0
Lease Financing	0	0	0	0	305	305	0
Total Loans	\$8,813	\$4,339	\$8,575	\$21,727	\$419,964	\$441,691	\$547

Nonaccrual Loans

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

- When there is doubt regarding the full repayment of interest and principal.
- When principal and/or interest on the loan has been in default for a period of 90-days or more, unless the asset is both well secured and in the process of collection that will result in repayment in the near future.
- When the loan is identified as having loss elements and/or is risk rated "8" Doubtful.
- Other circumstances which jeopardize the ultimate collectability of the loan including certain troubled debt restructurings, identified loan impairment, and certain loans to facilitate the sale of OREO.

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

Loans that are secured by one-to-four family residential properties (e.g., residential mortgage loans and home equity loans) on which principal and/or interest is due and unpaid for 90 days or more are placed on non-accrual and the accrual of interest for financial statement purposes is discontinued. Previously accrued but unpaid interest is reversed and charged against interest income.

Consumer loans to individuals for personal, family and household purposes, and unsecured or secured personal property where principal or interest is due and unpaid for 90 days or more are placed on non-accrual and the accrual of interest for financial statement purposes is discontinued. Previously accrued but unpaid interest is reversed and charged against interest income.

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

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

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

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

Nonaccrual loans totaled \$18.1 million and \$34.4 million at December 31, 2011 and 2010, respectively. There were no remaining undisbursed commitments to extend credit on nonaccrual loans at December 31, 2011 and 2010.

The following is a summary of nonaccrual loan balances at December 31, 2011 and 2010 (in thousands).

	December 31, 2011	December 31, 2010
Commercial and Business Loans	\$4,722	\$13,238
Government Program Loans	358	211
Total Commercial and Industrial	5,080	13,449
Commercial Real Estate Loans	3,946	1,405
Residential Mortgages	43	98
Home Improvement and Home Equity Loans	0	89
Total Real Estate Mortgage	3,989	1,592
Total RE Construction and Development Loans	9,014	16,003
Total Agricultural Loans	0	3,107
Consumer Loans	15	68
Overdraft protection Lines	0	0
Overdrafts	0	0
Total Installment	15	68
Lease Financing	0	175
Total Loans	\$18,098	\$34,394

Impaired Loans

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

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

A loan is not considered impaired if:

- There is merely an insignificant delay or shortfall in the amounts of payments.
- We expect to collect all amounts due, including interest accrued, at the contractual interest rate for the period of the delay.

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

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

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

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

Loans other than certain homogenous loan portfolios are reviewed on a quarterly basis for impairment. Impaired loans are written down to estimated realizable values by the establishment of specific reserves when required. The following is a summary of impaired loans at December 31, 2011.

December 31, 2011 (000's)	Unpaid Contractual Principal Balance	Recorded Investment With No Allowance	Recorded Investment With Allowance	Total Recorded Investment	Related Allowance	Average Recorded Investment
Commercial and Business Loans	\$6,521	\$4,002	\$2,425	\$6,427	\$112	\$11,102
Government Program Loans	704	212	0	212	0	\$301
Total Commercial and Industrial	7,225	4,214	2,425	6,639	112	11,403
Commercial Real Estate Loans	8,457	4,209	4,094	8,303	523	\$7,258
Residential Mortgages	3,569	494	3,037	3,531	166	\$3,619
Home Improvement and Home Equity Loans	36	22	15	37	1	\$96
Total Real Estate Mortgage	12,062	4,725	7,146	11,871	690	10,973
Total RE Construction and Development Loans	11,535	9,014	2,418	11,432	71	\$17,184
Total Agricultural Loans	2,445	61	1,792	1,853	381	\$2,139
Consumer Loans	88	87	0	87	0	\$184
Overdraft protection Lines	0	0	0	0	0	\$0
Overdrafts	0	0	0	0	0	\$0
Total Installment	88	87	0	87	0	184
Leases Financing	0	0	0	0	0	\$55
Total Impaired Loans	\$33,355	\$18,101	\$13,781	\$31,882	\$1,254	\$41,938

The following is a summary of impaired loans at December 31, 2010.

December 31, 2010 (000's)	Unpaid Contractual Principal Balance	Recorded Investment With No Allowance	Recorded Investment With Allowance	Total Recorded Investment	Related Allowance	Average Recorded Investment
Commercial and Business Loans	\$16,317	\$520	\$14,156	\$14,676	\$4,974	\$10,338
Government Program Loans	317	179	32	211	32	307
Total Commercial and Industrial	16,634	699	14,188	14,887	5,006	10,645
Commercial Real Estate Loans	6,448	2,761	3,664	6,425	476	7,386
Residential Mortgages	3,660	443	2,916	3,359	241	3,528
Home Improvement and Home Equity Loans	143	93	45	138	27	101
Total Real Estate Mortgage	10,251	3,297	6,625	9,922	744	11,015
Total RE Construction and Development Loans	26,584	5,572	17,187	22,759	4,890	23,725
Total Agricultural Loans	4,143	160	2,947	3,107	686	4,141
Consumer Loans	150	148	0	148	0	255
Overdraft protection Lines	0	0	0	0	0	0
Overdrafts	0	0	0	0	0	0
Total Installment	150	148	0	148	0	255
Lease Financing	175	175	0	175	0	54
Total Impaired Loans	\$57,937	\$10,051	\$40,947	\$50,998	\$11,326	\$49,835

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

Troubled Debt Restructurings

When the Company grants a concession to a borrower as part of a loan restructuring, the restructuring is accounted for as a troubled debt restructuring (TDR). TDR's are reported as a component of impaired loans.

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

For a restructured loan to return to accrual status there needs to, among other factors, be at least 6 months successful payment history. In addition, the Company performs a financial analysis of the credit to determine whether the borrower has the ability to continue to 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 tables illustrate TDR activity that occurred during the periods indicated (in thousands):

Year Ended December 31, 2011

	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post- Modification Outstanding Recorded Investment
Troubled Debt Restructurings			
Commercial and Business Loans	5	\$2,240	\$2,041
Government Program Loans	0	0	0
Commercial Real Estate Loans	2	3,542	2,506
Residential Mortgages Home Improvement and Home Equity Loans	2	852	847
RE Construction and Development Loans	0	0	0
Agricultural Loans	0	0	0
Consumer Loans	2	130	15
Overdraft protection Lines	0	0	0
Lease Financing	0	0	0
Total Loans	11	\$6,765	\$5,409

Year Ended December 31, 2011

	Number of Contracts	Recorded Investment
Troubled Debt Restructurings that Defaulted		
Commercial and Business Loans	2	\$132
Government Program Loans	0	0
Commercial Real Estate Loans	0	0
Single Family Residential Loans Home Improvement and Home Equity Loans	1	327
RE Construction and Development Loans	0	0
Agricultural Loans	0	0
Consumer Loans	1	85
Overdraft protection Lines	0	0
Lease Financing	0	0
Total Loans	4	\$545

The Company makes various types of concessions when structuring TDR's including rate reductions, payment extensions, and forbearance. At December 31, 2011, the Company had 41 restructured loans totaling \$19.0 million with no additional obligations as compared to 48 restructured loans totaling \$24.9 million at December 31, 2010, of which one (1) had additional obligations of \$36,000.

Credit Quality Indicators

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

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

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

Facility Rating:

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

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

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

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

Borrower Rating:

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

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

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

- *Grades 1 and 2* – These grades include loans which are given to high quality borrowers with high credit quality and sound financial strength. Key financial ratios are generally above industry averages and the

borrower strong earnings history or net worth. These may be secured by deposit accounts or high-grade investment securities.

- *Grade 3* – This grade includes loans to borrowers with solid credit quality with minimal risk. The borrower’s balance sheet and financial ratios are generally in line with industry averages, and the borrower has historically demonstrated the ability to manage economic adversity. Real estate and asset-based loans assigned this risk rating must have characteristics, which place them well above the minimum underwriting requirements.. Asset-based borrowers assigned this rating must exhibit extremely favorable leverage and cash flow characteristics, and consistently demonstrate a high level of unused borrowing capacity.
- *Grades 4 and 5* – These include “pass” grade loans to borrowers of acceptable credit quality and risk. The borrower’s balance sheet and financial ratios may be below industry averages, but above the lowest industry quartile. Leverage is above and liquidity is below industry averages. Inadequacies evident in financial performance and/or management sufficiency are offset by readily available features of support, such as adequate collateral, or good guarantors having the liquid assets and/or cash flow capacity to repay the debt. The borrower may have recognized a loss over three or four years ago, recent earnings trends, while perhaps somewhat cyclical, are improving and cash flows are adequate to cover debt service and fixed obligations. Real estate and asset-borrowers fully complying with all underwriting standards and are performing according to projections would be assigned this rating. These also include grade 5 loans which are “leveraged” or on management’s “watch list” While still considered pass loans, for loans given a grade 5, the borrower’s financial condition, cash flow or operations evidence more than average risk and short term weaknesses that warrant a higher than average level of monitoring, supervision and attention from the Company, but do not reflect credit weakness trends that weaken or inadequately protect the Company’s credit position. Loans with a grade rating are not normally acceptable as new credits unless they are adequately secured or carry substantial endorser/guarantors.
- *Grade 6* – This grade includes “special mention” loans which are loans that are currently protected but are potentially weak. This generally is an interim grade classification and should usually be upgraded to an Acceptable rating or downgraded to Substandard within a reasonable time period. Weaknesses in special mention loans may, if not checked or corrected, weaken the asset or inadequately protect the Company’s credit position at some future date. Special Mention loans are often loans with weaknesses inherent from the loan origination, loan servicing, and perhaps some technical deficiencies. The main theme in Special Mention credits is the distinct probability that the classification will deteriorate to a more adverse class if the noted deficiencies are not addressed by the loan officer or loan management.
- *Grade 7* – This grade includes “substandard” loans which are inadequately supported by the current sound net worth and paying capacity of the borrower or of the collateral pledged, if any. Substandard loans have a well-defined weakness or weaknesses that may impair the regular liquidation of the debt. Substandard loans exhibit a distinct possibility that the Company will sustain some loss if the deficiencies are not corrected. Substandard loans also include impaired loans.
- *Grade 8* - This grade includes “doubtful” loans which have all the same characteristics that the Substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions and values, highly questionable and improbable. The possibility of loss is extremely high, but because of certain important and reasonably specific pending factors, which may work to the advantage and strengthening of the loan, its classification as an estimated loss is deferred until its more exact status may be determined. Pending factors include a proposed merger, acquisition, or liquidation procedures, capital injection, perfecting liens on additional collateral and refinancing plans.
- *Grade 9* - This grade includes loans classified “loss” which are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value, but rather is not practical or desirable to defer writing off asset even though partial recovery may be achieved in the future.

The following tables summarize the credit risk ratings for commercial, construction, and other non-consumer related loans for December 31, 2011 and 2010. The Company did not carry any loans graded as loss at December 31, 2011 or 2010.

December 31, 2011 (000's)	Commercial and Lease Financing	Commercial RE	Construction	Agricultural	Total
Grades 1 and 2	725	0	0	40	765
Grade 3	184	7,026	897	0	8,107
Grades 4 and 5 – pass	149,815	104,468	28,596	33,990	316,869
Grade 6 – special mention	10,431	749	0	0	11,180
Grade 7 – substandard	5,320	6,614	20,097	1,781	33,812
Grade 8 – doubtful					
Total	166,475	118,857	49,590	35,811	370,733

December 31, 2010 (000's)	Commercial and Lease Financing	Commercial RE	Construction	Agricultural	Total
Grades 1 and 2	\$990	\$1,112	\$0	\$79	\$2,181
Grade 3	302	6,786	937	0	8,025
Grades 4 and 5 – pass	134,058	113,515	33,082	41,597	322,252
Grade 6 – special mention	7,770	4,419	10,737	1,525	24,451
Grade 7 – substandard	16,409	5,800	20,426	3,107	45,742
Grade 8 – doubtful	0	0	0	0	0
Total	\$159,529	\$131,632	\$65,182	\$46,308	\$402,651

The Company follows consistent underwriting standards outlined in its loan policy for consumer and other homogenous loans, but does not specifically assign a risk rating when these loans are originated. Consumer loans are monitored for credit risk and are considered “pass” loans until some issue or event requires that the credit be downgraded to special mention or worse. The following tables summarize the credit risk ratings for consumer related loans and other homogenous loans for December 31, 2011 and 2010.

(000's)	December 31, 2011				December 31, 2010			
	Single family Residential	Home Improvement	Installment	Total	Single family Residential	Home Improvement	Installment	Total
Not graded	18,858	1,801	9,615	30,274	\$18,236	\$2,225	\$11,429	\$31,890
Pass	4,796	22	1,163	5,981	3,964	22	1,313	5,299
Special Mention	0	0	423	423	195	0	0	195
Substandard	377	36	81	494	1,369	138	149	1,656
Total	24,031	1,859	11,282	37,172	\$23,764	\$2,385	\$12,891	\$39,040

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

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

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

Commercial real estate loans – This segment is considered to have more risk in part because of the vulnerability of commercial businesses to economic cycles as well as the exposure to fluctuations in real estate

prices because most of these loans are secured by real estate. Losses in this segment have however been historically low because most of the loans are real estate secured.

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

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

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

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

Consumer loans (including three segments: consumer loans, overdrafts, and overdraft protection lines) – This segment is higher risk because many of the loans are unsecured.

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

The following summarizes the activity in the allowance for credit losses by loan category for the years ended December 31, 2011 and 2010.

2011 (in 000's)	Commercial and Industrial	Real Estate Mortgage	RE Construction Development	Agricultural	Installment & Other	Lease Financing	Unallocated	Total
Beginning balance	8,209	1,620	5,763	850	49	3	26	16,520
Provision for credit losses	7,268	114	5,563	-342	676	108	215	13,602
Charge-offs	(9,340)	((453)	(6,771)	-	(620)	(110)		(17,294)
Recoveries	650	135	24	-	11	-		820
Net charge-offs	(8,690)	(318)	(6,747)	-	(609)	(110)	-	(16,473)
Ending balance	\$6,787	\$1,416	\$4,579	\$508	\$116	\$1	\$241	\$13,648
Period-end amount allocated to:								
Loans individually evaluated								
for impairment	112	690	71	381	0	0	0	1,254
Loans collectively evaluated								
for impairment	6,675	726	4,508	127	116	1	241	12,395
Ending balance	\$6,787	\$1,416	\$4,579	\$508	\$116	\$1	\$241	\$13,648

2010 (in 000's)	Commercial and Industrial	Real Estate Mortgage	RE Construction Development	Agricultural	Installment & Other	Lease Financing	Unallocated	Total
Beginning balance	7,125	1,426	5,561	334	535	35	0	15,016
Provision for credit losses	3,639	1,610	5,613	1,181	357	49	26	12,475
Charge-offs	(3,484)	(1,416)	(5,421)	(676)	(858)	(81)		(11,936)
Recoveries	929	0	10	11	15	0		965
Net charge-offs	(2,555)	(1,416)	(5,411)	(665)	(843)	(81)	0	(10,971)
Ending balance	8,209	1,620	5,763	850	49	3	26	16,520
Period-end amount allocated to:								
Loans individually evaluated for impairment	5,006	744	4,890	686	0	0	0	11,326
Loans collectively evaluated for impairment	3,203	876	873	164	49	3	26	5,194
Ending balance	8,209	1,620	5,763	850	49	3	26	16,520

The following summarizes information with respect to the loan balances at December 31, 2011 and 2010.

(000's)	December 31, 2011			December 31, 2010		
	Loans Individually Evaluated	Loans Collectively Evaluated for Impairment	Total Loans	Loans Individually Evaluated	Loans Collectively Evaluated for Impairment	Total Loans
	for Impairment	for Impairment	Loans	for Impairment	for Impairment	Loans
Commercial and Business Loans	\$6,427	\$157,015	\$163,442	\$14,676	\$139,948	\$154,624
Government Program Loans	212	2772	2,984	211	4,389	4,600
Total Commercial and Industrial	6,639	159,787	166,426	14,887	144,337	159,224
Commercial Real Estate Loans	8,303	110,554	118,857	6,425	125,207	131,632
Residential Mortgage Loans	3,531	20,500	24,031	3,359	20,405	23,764
Home Improvement and Home Equity Loans	37	1822	1,859	138	2,247	2,385
Total Real Estate Mortgage	11,871	132,876	144,747	9,922	147,859	157,781
Total RE Construction and Development Loans	11,432	38,968	50,400	22,759	42,423	65,182
Total Agricultural Loans	1,853	33,958	35,811	3,107	43,201	46,308
Total Installment Loans	87	11,195	11,282	148	12,743	12,891
Commercial Leases Financing	0	49	49	175	130	305
Total Loans	\$31,882	\$376,833	\$408,715	\$50,998	\$390,693	\$441,691

4. Premises and Equipment

The components of premises and equipment are as follows:

<i>(In thousands)</i>	December 31,	
	2011	2010
Land	\$968	\$968
Buildings and improvements	14,416	14,372
Furniture and equipment	9,316	8,446
	<u>24,700</u>	<u>23,786</u>
Less accumulated depreciation and amortization	(12,025)	(10,877)
Total premises and equipment	<u>\$12,675</u>	<u>\$12,909</u>

Total depreciation expense on Company premises and equipment totaled \$1.1 million and \$1.5 million for the years ended December 31, 2011, and 2010, respectively, and is included in occupancy expense in the accompanying consolidated statements of operations.

5. Investment in Limited Partnership

The Bank owns limited interests in private limited partnerships that acquire affordable housing properties in California that generate Low Income Housing Tax Credits under Section 42 of the Internal Revenue Code of 1986, as amended. The Bank's limited partnership investment is accounted for under the equity method. The Bank's noninterest expense associated with the utilization and expiration of these tax credits for the years ended December 31, 2011 and 2010 was \$418,000 and \$424,000, respectively. The limited partnership investments are expected to generate tax credits of approximately \$1.8 million over the life of the investment. The tax credits expire between 2012 and 2014. Tax credits utilized for income tax purposes for the years ended December 31, 2011 and 2010 totaled \$260,000 and \$377,000, respectively.

6. Deposits

Deposits include the following:

<i>(In thousands)</i>	December 31,	
	2011	2010
Noninterest-bearing deposits	\$224,907	\$139,690
Interest-bearing deposits:		
NOW and money market accounts	165,937	181,061
Savings accounts	40,099	37,177
Time deposits:		
Under \$100,000	53,271	58,629
\$100,000 and over	90,213	140,909
Total interest-bearing deposits	<u>349,520</u>	<u>417,776</u>
Total deposits	<u>\$574,427</u>	<u>\$557,466</u>

At December 31, 2011, the scheduled maturities of all certificates of deposit and other time deposits are as follows:

<i>(In thousands)</i>	
One year or less	\$129,043
More than one year, but less than or equal to two years	12,060
More than two years, but less than or equal to three years	905
More than three years, but less than or equal to four years	626
More than four years, but less than or equal to five years	713
More than five years	137
	<u>\$143,484</u>

The Company may utilize brokered deposits as an additional source of funding. At December 31, 2011 and 2010, the Company held brokered time deposits totaling \$40.9 million and \$81.5 million, respectively. Of this balance at December 31, 2011, \$40.3 million is included in time deposits of \$100,000 or more, and the remaining \$598,000 is included in time deposits of less than \$100,000. Included in brokered time deposits at December 31, 2011 are balances totaling \$19.5 million maturing in three months or less, \$15.3 million maturing in three to six months, and \$6.0 million maturing in 6 to twelve months.

Deposit balances representing overdrafts reclassified as loan balances totaled \$123,000 and \$355,000 as of December 31, 2011 and 2010, respectively.

Deposits of directors, officers and other related parties to the Bank totaled \$4.7 million and \$3.7 million at December 31, 2011 and 2010, respectively. The rates paid on these deposits were those customarily paid to the Bank's customers in the normal course of business.

7. Short-term Borrowings/Other Borrowings

At December 31, 2011, the Company had collateralized and uncollateralized lines of credit with the Federal Reserve Bank of San Francisco and other correspondent banks aggregating \$250.1 million, as well as Federal Home Loan Bank ("FHLB") lines of credit totaling \$17.6 million. At December 31, 2011, the Company had no outstanding borrowing balances. The weighted average cost of borrowings for the year ended December 31, 2011 was 0.73%. These lines of credit generally have interest rates tied to the Federal Funds rate or are indexed to short-term U.S. Treasury rates or LIBOR. FHLB advances are collateralized by all of the Company's stock in the FHLB, investment securities, and certain qualifying mortgage loans. As of December 31, 2011, \$18.5 million in investment securities at FHLB were pledged as collateral for FHLB advances. Additionally, \$346.9 million in real estate-secured loans were pledged at December 31, 2011 as collateral for used and unused borrowing lines with the Federal Reserve Bank totaling \$232.5 million. All lines of credit are on an "as available" basis and can be revoked by the grantor at any time.

The Company had collateralized and uncollateralized lines of credit with the Federal Reserve Bank of San Francisco and other correspondent banks aggregating \$118.7 million, as well as Federal Home Loan Bank ("FHLB") lines of credit totaling \$32.6 million at December 31, 2010. At December 31, 2010, the Company had total outstanding balances of \$32.0 million in borrowings drawn against its FHLB lines of credit at an average rate of 0.34%.

8. Junior Subordinated Debt/Trust Preferred Securities

During July 2007, the Company formed USB Capital Trust II, a wholly-owned special purpose entity, for the purpose of issuing Trust Preferred Securities. USB Capital Trust II is a Variable Interest Entity (VIE) and a deconsolidated entity pursuant to ASC 810. On July 23, 2007, USB Capital Trust II issued \$15 million in Trust Preferred securities. The securities have a thirty-year maturity and bear a floating rate of interest (repricing quarterly) of 1.29% over the three-month LIBOR rate (initial coupon rate of 6.65%). Interest will be paid quarterly. Concurrent with the issuance of the Trust Preferred securities, USB Capital Trust II used the proceeds of the Trust Preferred securities offering to purchase a like amount of junior subordinated debentures of the Company. The Company will pay interest on the junior subordinated debentures to USB Capital Trust II, which represents the sole source of dividend distributions to the holders of the Trust Preferred securities. The Company may redeem the junior subordinated debentures during October as follows: 2011 at 100.66, and at par anytime after October 2012.

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

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

its stock. At December 31, 2011 and 2010, the Company had \$624,000 and \$381,000, respectively, in accrued and unpaid interest on the junior subordinated debt.

At December 31, 2011, as with previous periods, the Company performed a fair value measurement analysis on its junior subordinated debt using a discounted cash flow valuation model approach to determine the present value of those cash flows. The cash flow model utilizes the forward 3-month Libor curve to estimate future quarterly interest payments due over the life of the debt instrument, adjusted for deferrals of interest payments per the Company's election at September 30, 2009 expected to be paid cumulatively in approximately one year. These cash flows were discounted at a rate which incorporates a current market rate for similar-term debt instruments, adjusted for additional credit and liquidity risks associated with the junior subordinated debt. Although there is little market data in the current relatively illiquid credit markets, we believe the 7.6% discount rate used represents what a market participant would consider under the circumstances based on current market assumptions.

The fair value calculation performed resulted in a realized gain of \$1.9 million and \$316,000 for the year ended December 31, 2011 and 2010, respectively. Fair value gains and losses are reflected as a component of noninterest income.

9. Taxes on Income

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

<i>(In thousands)</i>	December 31,	
	2011	2010
Deferred tax assets:		
Credit losses not currently deductible	\$5,016	\$5,773
State franchise tax	0	126
Deferred compensation	1,797	1,670
Net operating losses	9,581	2,917
Depreciation	344	326
Accrued reserves	164	79
Write-down on other real estate owned	2,873	1,419
Impairment loss on CMO's	1,214	739
Capitalized OREO expenses	1,371	976
Unrealized loss on AFS securities	209	57
Other	1,356	529
Total deferred tax assets	23,925	14,611
Deferred tax liabilities:		
State Tax	(2,245)	0
FHLB dividend	(201)	(196)
Loss on limited partnership investment	(2283)	(2,066)
Amortization of core deposit intangible	0	(311)
Deferred gain SFAS No. 159 – fair value option	(3,166)	(2,139)
Fair value adjustments for purchase accounting	(122)	(120)
Interest on nonaccrual loans	(101)	(338)
Deferred loan costs	(228)	(212)
Prepaid expenses	(408)	(351)
Total deferred tax liabilities	(8,754)	(5,733)
Valuation Allowance	(3,686)	0
Net deferred tax assets	\$11,485	\$8,878

The Company periodically evaluates its deferred tax assets to determine whether a valuation allowance is required based upon a determination that some or all of the deferred assets may not be ultimately realized. At December 31, 2011, the Company had a recorded valuation allowance of \$3.7 million. At December 31, 2010, the Company had concluded that it was more likely than not that the deferred tax assets would be recognized in the normal course of business, therefore no valuation allowance was recorded on that date.

Taxes on income for the years ended December 31, consist of the following:

(In thousands)

	Federal	State	Total
2011:			
Current	\$(1,468)	\$2,152	\$684
Deferred	1,181	(3,580)	(2,399)
	\$(287)		\$(1,715)
2010:			
Current	\$(2,077)	\$1,430	\$(647)
Deferred	(296)	(2,273)	(2,569)
	\$(2,373)	\$(843)	\$(3,216)

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

	Years Ended December 31,	
	2011	2010
Statutory federal income tax rate	34.0%	34.0%
State franchise tax, net of federal income tax benefit	10.1	7.2
Tax exempt interest income	0	0.2
Low Income Housing – federal credits	0	4.3
Cash surrender value of life insurance	1.4	2.5
Goodwill impairment	(4.4)	(6.3)
Valuation Allowance	(27.4)	0
Other	0	0.6
	13.7%	42.5%

At December 31, 2011 the Company has remaining federal net operating loss carry-forwards totaling \$10.5 million, and remaining state net operating loss carry-forwards totaling \$55.4 million which expire between 2016 and 2031.

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

The Company and its subsidiary file income tax returns in the U.S federal jurisdiction, and several states within the U.S. There are no filings in foreign jurisdictions. During 2010, the Company amended its federal tax returns for the year 2004 through 2009 to utilize the five-year NOL carry-back provisions allowed by the IRS for 2009. These amended tax returns are currently under audit by the IRS. The Company anticipates that the examination will be completed during the second quarter of 2012 and that the outcome of the examination will not have a material effect on the Company's financial statements.

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. Then in 2011, the Company, under the provisions of Franchise Tax Board Voluntary Compliance Initiative Program (VCI 2), the Company settled its case.

The Company is not currently aware of any other tax jurisdictions where the Company or any subsidiary is subject to examination by federal, state, or local taxing authorities.

The following table reconciles REIT liability during 2011:

Balance at January 1, 2011	\$1,669
Settlements	<u>(1,669)</u>
Balance at December 31, 2011	<u>0</u>

10. Stock Based Compensation

Options have been granted to officers and key employees at an exercise price equal to estimated fair value at the date of grant as determined by the Board of Directors. All options granted are service awards, and as such are based solely upon fulfilling a requisite service period (the vesting period). In May 2005, the Company's shareholders approved the adoption of the United Security Bancshares 2005 Stock Option Plan (2005 Plan). At the same time, all previous plans, including the 1995 Plan, were terminated. The 2005 Plan provides for the granting of up to 574,737 shares of authorized and unissued shares of common stock at option prices per share which must not be less than 100% of the fair market value per share at the time each option is granted.

The options granted (incentive stock options for employees and non-qualified stock options for Directors) have an exercise price at the prevailing market price on the date of grant. All options granted are exercisable 20% each year commencing one year after the date of grant and expire ten years after the date of grant.

Under the 2005 Plan, 154,757 granted shares are outstanding (127,172 incentive stock options and 27,585 nonqualified stock options) as of December 31, 2011, of which 128,980 are vested.

Options outstanding, exercisable, exercised and forfeited are as follows:

	2005 Plan	Weighted Average Exercise Price
Options outstanding December 31, 2010	219,605	\$12.70
Granted during the year	4,120	3.13
Exercised during the year	-	-
Forfeited during the year	68,968	12.56
Options outstanding December 31, 2011	<u>154,757</u>	<u>\$12.50</u>

Included in total outstanding options at December 31, 2011, are 128,980 exercisable shares at a weighted average price of \$14.16, a weighted average remaining contract term of 4.13 years and no intrinsic value,

Included in salaries and employee benefits for the years ended December 31, 2011 and 2010 is \$18,000 and \$41,000 of share-based compensation, respectively. The related tax benefit on share-based compensation recorded in the provision for income taxes was not material to either year.

As of December 31, 2011, and 2010, there was \$19,000 and \$37,000, respectively, of total unrecognized compensation expense related to nonvested stock options. This cost is expected to be recognized over a weighted average period of approximately 1.0 years. No options were exercised during 2011 or 2010.

	Year Ended December 31, 2011	Year Ended December 31, 2010
Weighted average grant-date fair value of stock options granted	\$2.06	\$2.22
Total fair value of stock options vested	\$129,864	\$110,947
Total intrinsic value of stock options exercised	n/a	n/a

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

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

The Bank expenses the fair value of the option on a straight-line basis over the vesting period for each separately vesting portion of the award. The Bank estimates forfeitures and only recognizes expense for those shares expected to vest. Based upon historical evidence, the Company has determined that because options are granted to a limited number of key employees rather than a broad segment of the employee base, expected forfeitures, if any, are not material. The Company granted 4,102 shares and 25,000 shares in incentive stock options during 2011 and 2010, respectively. The assumptions used for the 2011 and 2010 stock option grant are as follows.

	Year Ended December 31, 2011	Year Ended December 31, 2010
Risk Free Interest Rate	2.11%	2.71%
Expected Dividend Yield	0.00%	0.00
Expected Life in Years	5.50 Years	6.50 years
Expected Price Volatility	76.18%	43.07%

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

11. Employee Benefit Plans

Employee Stock Ownership Plan

The Company has an Employee Stock Ownership Plan and Trust, (the "ESOP"), designed to enable eligible employees to acquire shares of common stock. ESOP eligibility is based upon length of service requirements. The Bank contributes cash to the ESOP in an amount determined at the discretion of the Board of Directors. The trustee of the ESOP uses such contribution to purchase shares of common stock currently outstanding, or to repay debt on the leveraged portion of the ESOP, if applicable. The shares of stock purchased by the trustee are then

allocated to the accounts of the employees participating in the ESOP on the basis of total relative compensation. Employer contributions vest over a period of six years.

The Company did not make a contribution to the ESOP during 2010 or 2011 and therefore had no ESOP compensation expense during the years ended December 31, 2010 or 2011. During 2011, the Company's Board of Directors approved a plan to merge the ESOP into the Company's Cash or Deferred 401(k) Stock Ownership Plan, effective August 15, 2011. As of this date, benefits ceased to accrue and as of December 31, 2011 all assets were transferred out of the ESOP.

Allocated, committed-to-be-released, and unallocated ESOP shares as of December 31, 2010 were as follows:

	2010
Allocated	541,318
Committed-to-be-released	0
Unallocated	0
Total ESOP shares	<u>541,318</u>
Fair value of unreleased shares	<u>N/A</u>

401K Plan

The Company has a Cash or Deferred 401(k) Stock Ownership Plan (the "401(k) Plan") organized under Section 401(k) of the Code. All employees of the Company are initially eligible to participate in the 401(k) Plan upon the first day of the month after date of hire. Under the terms of the plan, the participants may elect to make contributions to the 401(k) Plan as determined by the Board of Directors. Participants are automatically vested 100% in all employee contributions. Participants may direct the investment of their contributions to the 401(k) Plan in any of several authorized investment vehicles. The Company contributes funds to the Plan up to 5% of the employees' eligible annual compensation. Company contributions are subject to certain vesting requirements over a period of six years. Contributions made by the Company are invested in Company stock. During 2011, the Company made a matching contribution of \$172,000 to the 401(k) Plan. The Company made no matching contribution to the 401(k) Plan in 2010.

Salary Continuation Plan

The Company has an unfunded, non-qualified Salary Continuation Plan for senior executive officers and certain other key officers of the Company, which provides additional compensation benefits upon retirement for a period of 15 years. Future compensation under the Plan is earned by the employees for services rendered through retirement and vests over a period of 12 to 15 years. The Company accrues for the salary continuation liability based on anticipated years of service and vesting schedules provided under the Plan. The Company's current benefit liability is determined based upon vesting and the present value of the benefits at a corresponding discount rate. The discount rate used is an equivalent rate for high-quality investment-grade bonds with lives matching those of the service periods remaining for the salary continuation contracts, which averages approximately 20 years. At December 31, 2011 and 2010, \$4.0 million and \$3.9 million, respectively, had been accrued to date, based on a discounted cash flow using an average discount rate of 3.57% and 3.90%, respectively, and is included in other liabilities. In connection with the implementation of the Salary Continuation Plans, the Company purchased single premium universal life insurance policies on the life of each of the key employees covered under the Plan. The Company is the owner and beneficiary of these insurance policies. The cash surrender value of the policies was \$4.2 million and \$4.1 million December 31, 2011 and 2010, respectively. Although the Plan is unfunded, the Company intends to utilize the proceeds of such policies to settle the Plan obligations. Under Internal Revenue Service regulations, the life insurance policies are the property of the Company and are available to satisfy the Company's general creditors.

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

As of December 31, 2011 and 2010, the Company had approximately \$395,000 and \$321,000, respectively in unrecognized net periodic benefit costs arising from changes in interest rates used in calculating the current post-retirement liability required under the plan. This amount represents the difference between the plan liabilities calculated under net present value calculations, and the net plan liabilities actually recorded on the Company's books at December 31, 2011 and 2010.

Salary continuation expense is included in salaries and benefits expense, and totaled \$101,000 and \$72,000 for the years ended December 31, 2011 and 2010, respectively.

Officer Supplemental Life Insurance Plan

The Company owns single premium Bank-owned life insurance policies (BOLI) on certain officers with a portion of the death benefits available to the officers' beneficiaries. The BOLI's initial net cash surrender value is equivalent to the premium paid, and it adds income through non-taxable increases in its cash surrender value, net of the cost of insurance, plus any death benefits ultimately received by the Company. The cash surrender value of these insurance policies totaled \$16.1 million and \$15.5 million at December 31, 2011 and December 31, 2010, and is included on the consolidated balance sheet in cash surrender value of life insurance. Income on these policies, net of expense, totaled approximately \$565,000 and \$554,000 for the years ended December 31, 2011 and 2010, respectively.

12. Commitments and Contingent Liabilities

Lease Commitments: The Company leases land and premises for its branch banking offices and administration facilities. The initial terms of these leases expire at various dates through 2021. Under the provisions of most of these leases, the Company has the option to extend the leases beyond their original terms at rental rates adjusted for changes reported in certain economic indices or as reflected by market conditions. The total expense on land and premises leased under operating leases was \$564,000 and \$781,000 during 2011 and 2010, respectively. Total rent expense for the years ended December 31, 2011, and 2010 included approximately \$5,000 and \$28,000 in reductions, respectively, related to adjustments made pursuant to ASC Topic 840, "Leases". The adjustments represent the difference between contractual rent amounts paid and rent amounts actually expensed under the straight-line method pursuant to ASC 840.

Future minimum rental commitments under existing non-cancelable leases as of December 31, 2011 are as follows:

<i>(In thousands):</i>	
2012	484
2013	491
2014	445
2015	365
2016	230
Thereafter	719
	<u>\$2,734</u>

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

<i>(in thousands)</i>	Contractual amount – December 31,	
	2011	2010
Commitments to extend credit	\$62,399	\$67,829
Standby letters of credit	2,404	1,756

Commitments to extend credit are agreements to lend to a customer, as long as there is no violation of any condition established in the contract. Substantially all of these commitments are at floating interest rates based on

the Prime rate, and most have fixed expiration dates. The Company evaluates each customer's creditworthiness on a case-by-case basis, and the amount of collateral obtained, if deemed necessary, is based on management's credit evaluation. Collateral held varies but includes accounts receivable, inventory, leases, property, plant and equipment, residential real estate and income-producing properties. Many of the commitments are expected to expire without being drawn upon and, as a result, the total commitment amounts do not necessarily represent future cash requirements of the Company.

Standby letters of credit are generally unsecured and are issued by the Company to guarantee the performance of a customer to a third party. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loans to customers. The Company's letters of credit are short-term guarantees and have terms from less than one month to approximately 2.5 years. At December 31, 2011, the maximum potential amount of future undiscounted payments the Company could be required to make under outstanding standby letters of credit totaled \$2.4 million.

13. Fair Value Measurements and Disclosure

The following summary disclosures are made in accordance with the accounting standards related to fair value measurements and disclosure, which requires the disclosure of fair value information about both on- and off-balance sheet financial instruments where it is practicable to estimate that value.

	December 31, 2011		December 31, 2010	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
<i>(In thousands)</i>				
Financial Assets:				
Cash and cash equivalents	\$124,184	\$124,184	\$98,430	\$98,430
Interest-bearing deposits	2,187	2,250	4,396	4,523
Investment securities	38,458	38,458	51,503	51,503
Loans	394,498	398,837	424,526	429,249
Cash surrender value of life insurance	16,150	16,150	15,493	15,493
Accrued interest receivable	1,946	1,946	2,152	2,152
Financial Liabilities:				
Deposits	574,427	574,370	557,466	557,240
Borrowings	0	-0	32,000	31,996
Junior Subordinated Debt	9,028	9,028	10,646	10,646
Accrued interest payable	111	111	222	222
Commitments to extend credit	--	--	--	--
Standby letters of credit	--	--	--	--

Current accounting standards clarify the definition of fair value, describe methods generally used to appropriately measure fair value in accordance with generally accepted accounting principles and expand fair value disclosure requirements. Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. The statement applies whenever other accounting pronouncements require or permit fair value measurements.

Some fair value measurements, such as for available-for-sale securities and junior subordinated debt are performed on a recurring basis, while others, such as impairment of goodwill, other real estate owned, impaired loans that are collateral dependent, and other intangibles, are performed on a nonrecurring basis.

The following tables summarize the Company's assets and liabilities that were measured at fair value on a recurring and non-recurring basis as of December 31, 2011 (in 000's):

Description of Assets (000's)	December 31, 2011	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
AFS Securities:				
Other investment securities	\$0	\$0		
U.S Govt agencies	25,028		25,028	
U.S Govt collateralized mortgage obligations	5,428		5,428	
Obligations of state and political subdivisions	0		0	
Private label residential mortgage obligations	7,973			7,973
Total AFS securities	38,459	0	30,456	7,973
Impaired Loans (1):				
Commercial and industrial	6,527			6,527
Real estate mortgage	11,181			11,181
RE construction & development	11,361			11,361
Agricultural	1,472			1,472
Installment/Other	87			87
Total impaired loans	30,628	0	0	30,628
Other real estate owned (1)	10,519			10,519
Goodwill (1)	2,861			2,861
Core deposit intangible (1)	12			12
Total	\$82,449	\$23	\$30,456	\$51,993

(1) Nonrecurring

Description of Liabilities (000's)	December 31, 2011	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Junior subordinated debt	9,027			9,027
Total	9,027	0	0	9,027

The following tables summarize the Company's assets and liabilities that were measured at fair value on a recurring and non-recurring basis as of December 31, 2010 (in 000's):

Description of Assets (000's)	December 31, 2010	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
AFS Securities:				
Other investment securities	\$0	\$0		
U.S Govt agencies	33,788		33,788	
U.S Govt collateralized mortgage obligations	7,755		7,755	
Obligations of state and political subdivisions	0		0	
Private label residential mortgage obligations	9,960			9,960
Total AFS securities	51,503	0	41,543	9,960
Impaired Loans (1):				
Commercial and industrial	9,330			9,330
Real estate mortgage	6,096			6,096
RE construction & development	13,209			13,209
Agricultural	2,261			2,261
Installment/Other	0			0
Total impaired loans	30,896	0	0	30,896
Other real estate owned (1)	19,016			19,016
Goodwill (1)	4,350			4,350
Core deposit intangible (1)	344			344
Total	\$106,109	\$0	\$41,543	\$64,566
(1) Nonrecurring				

Description of Liabilities (000's)	December 31, 2010	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Junior subordinated debt	10,646			10,646
Total	10,646	0	0	10,646

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

	12/31/11	12/31/10
	Private label residential mortgage obligations	Private label residential mortgage obligations
<u>Reconciliation of Assets:</u>		
Beginning balance	\$9,960	\$9,714
Total gains or (losses) included in earnings (or other comprehensive loss)	(1,988)	246
Transfers in and/or out of Level 3	0	0
Ending balance	<u>\$7,972</u>	<u>\$9,960</u>

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

(\$1,988)	\$246
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Reconciliation of Liabilities:

	12/31/2011 Junior Subordinated Debt	12/31/2010 Junior Subordinated Debt
Beginning balance	\$10,646	\$10,716
Total gains included in earnings (or changes in net assets)	(1,619)	(70)
Transfers in and/or out of Level 3	0	0
Ending balance	<u>\$9,027</u>	<u>\$10,646</u>

The amount of total gains for the period included in earnings (or changes in net assets) attributable to the change in unrealized gains or losses and accrued interest relating to liabilities still held at the reporting date

(\$1,619)	(\$70)
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The following methods and assumptions were used in estimating the fair values of financial instruments:

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

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

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

fair market value are recorded through other comprehensive loss as the securities are available for sale. At December 31, 2011 and December 31, 2010, the Company held three non-agency private-label residential mortgage obligations. Fair value of these securities (as well as review for other-than-temporary impairment) was performed by a third-party securities broker specializing in private label residential mortgage obligations using the discounted cash flow method. Fair value was based upon estimated cash flows which included assumptions about future prepayments, default rates, and the impact of credit risk on this type of investment security. Although the pricing of the private label residential mortgage obligations has certain aspects of Level 2 pricing, many of the pricing inputs are based upon unobservable assumptions of future economic trends and as a result the Company considers this to be Level 3 pricing.

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

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

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

Goodwill and Core Deposit Intangibles - Fair value is determined on a discounted cash flow methodology using estimated market discount rates and projections of future cash flows for the related operating unit. In addition to projected cash flows, other market metrics are utilized including industry multiples of earnings and price-to-book ratios to estimate what a market participant would pay for the operating unit in the current business environment. Determining the fair value involves a significant amount of judgment, including estimates of changes in revenue growth, changes in discount rates, competitive forces within the industry, and other specific industry and market valuation conditions. If it is determined that goodwill impairment exists, impairment amounts are recorded as an impairment loss in other noninterest expense, and the carrying value of goodwill is reduced by the amount of the impairment. Core deposit intangibles are amortized over the estimated useful lives of the related deposits and are evaluated for impairment periodically. Core deposit intangibles are reviewed for impairment utilizing a discounted cash flow methodology based upon the anticipated deposit runoff over the estimated lives of the deposits, generally six to eight years. If it is determined that impairment exists on the core deposit intangible, impairment amounts are recorded as an impairment loss in other noninterest expense, and the carrying value of core deposit intangible is reduced by the amount of the impairment.

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

Deposits - In accordance with authoritative accounting guidance, fair values for transaction and savings accounts are equal to the respective amounts payable on demand at December 31, 2011 and December 31, 2010 (i.e., carrying amounts). Fair values of fixed-maturity certificates of deposit were estimated using the rates currently offered for deposits with similar remaining maturities.

Borrowings - Borrowings consist of federal funds sold, securities sold under agreements to repurchase, and other short-term borrowings. Fair values of borrowings were estimated using the rates currently offered for borrowings with similar remaining maturities.

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

use, and considered factors specific to (a) the liability, (b) the principal (or most advantageous) market for the liability, and (c) market participants with whom the reporting entity would transact in that market. For the years ended December 31, 2011 and 2010, cash flows were discounted at a rate which incorporates a current market rate for similar-term debt instruments, adjusted for credit and liquidity risks associated with similar junior subordinated debt and circumstances unique to the Company. The Company believes that the subjective nature of these inputs, due primarily to the current economic environment, require the junior subordinated debt to be classified as a Level 3 fair value.

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

Off-balance sheet Instruments - Off-balance sheet instruments consist of commitments to extend credit, standby letters of credit and derivative contracts. The contract amounts of commitments to extend credit and standby letters of credit are disclosed in Note 12. Fair values of commitments to extend credit are estimated using the interest rate currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the present counterparties' credit standing. There was no material difference between the contractual amount and the estimated value of commitments to extend credit at December 31, 2011 and 2010.

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

14. Regulatory Matters

Regulatory Agreement with the Federal Reserve Bank of San Francisco

Effective March 23, 2010, United Security Bancshares (the "Company") and its wholly owned subsidiary, United Security Bank (the "Bank"), entered into a written agreement (the "Agreement") with the Federal Reserve Bank of San Francisco. Under the terms of the Agreement, the Company and the Bank agreed, 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 Holding Company's ability to meet its ongoing operating obligations.

This Agreement entered into with the Federal Reserve Bank of San Francisco was a result of a regulatory examination that was conducted by the Federal Reserve and the California Department of Financial Institutions in June 2009 ("Report of Examination"). The Agreement was the result of significant increases in nonperforming assets, both classified loans and OREO, during 2008 and 2009 increasing the overall risk profile of the Bank. The increased risk profile of the Bank included heightened concerns about the Bank's use of brokered and other 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 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.

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. One such additional requirement is that the Bank must maintain a ratio of tangible shareholders' equity to total tangible assets equal to or greater than 9.5%.

As of December 31, 2011, the Bank is compliance with the requirements of the Agreement and the Order including its deadlines, except for certain provisions pertaining to the methodology and documentation of its ALLL. 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.

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

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 10.5% and 11.7% at December 31, 2011 and 2010, respectively.

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.

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

<i>(In thousands)</i>	Actual		For Capital Adequacy Purposes		To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
<u>As of December 31, 2011 (Company):</u>						
Total Capital (to Risk Weighted Assets)	\$63,522	12.93%	\$39,303	8.00%	N/A	N/A
Tier 1 Capital (to Risk Weighted Assets)	57,286	11.66%	19,651	4.00%	N/A	N/A
Tier 1 Capital (to Average Assets)	57,286	8.79%	26,068	4.00%	N/A	N/A
<u>As of December 31, 2011 (Bank):</u>						
Total Capital (to Risk Weighted Assets)	\$63,672	12.91%	\$39,460	8.00%	\$49,325	10.00%
Tier 1 Capital (to Risk Weighted Assets)	57,412	11.64%	19,730	4.00%	29,595	6.00%
Tier 1 Capital (to Average Assets)	57,412	9.02%	25,454	4.00%	31,817	5.00%
<u>As of December 31, 2010 - (Company):</u>						
Total Capital (to Risk Weighted Assets)	\$86,175	16.17%	\$42,635	8.00%	N/A	N/A
Tier 1 Capital (to Risk Weighted Assets)	79,389	14.90%	21,317	4.00%	N/A	N/A
Tier 1 Capital (to Average Assets)	79,389	11.50%	27,602	4.00%	N/A	N/A
<u>As of December 31, 2010 - (Bank):</u>						
Total Capital (to Risk Weighted Assets)	\$82,712	15.58%	\$42,272	8.00%	\$53,091	10.00%
Tier 1 Capital (to Risk Weighted Assets)	76,173	14.35%	21,236	4.00%	31,854	6.00%
Tier 1 Capital (to Average Assets)	76,173	11.04%	27,602	4.00%	34,503	5.00%

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 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 of which must be in the form of Tier 1 capital.

Under the regulatory Prompt Corrective Action Provisions within the Agreement and the Order, the Bank cannot be considered "Well Capitalized". However, as of December 31, 2011, the Company and the Bank meets all capital adequacy requirements to which they are subject.

Under regulatory guidelines, the \$15 million in Trust Preferred Securities issued by USB Capital Trust II in July of 2007 qualifies as Tier 1 capital up to 25% of Tier 1 capital. Any additional portion of Trust Preferred Securities qualifies as Tier 2 capital.

Dividends – Cash dividends, if any, paid to shareholders are paid by the bank holding company, subject to restrictions set forth in the California General Corporation Law. All dividends paid during 2011 and 2010 were in the form of stock dividends rather than cash dividends.

The primary source of funds with which cash dividends are paid to shareholders comes from cash dividends received by the Company from the Bank. The Company received no cash dividends from the Bank during the year ended December 31, 2011 or 2010.

Under California state banking law, 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 California State Department of Financial Institutions, in an amount not exceeding the greater of: (i) the Bank's retained earnings; (ii) its net income for the last fiscal year; or (iii) its net income for the current fiscal year. 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.

Cash Restrictions - The Bank is required to maintain average reserve balances with the Federal Reserve Bank. In prior years, 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 both December 31, 2011 and 2010, the Bank's qualifying balance with the Federal Reserve Bank was \$25,000 consisting of vault cash and balances.

15. Supplemental Cash Flow Disclosures

<i>(In thousands)</i>	Year Ended December 31,	
	2011	2010
Cash paid during the period for:		
Interest	\$3,076	\$4,742
Income Taxes	2,876	3,251
Noncash investing activities:		
Loans transferred to foreclosed property	2,806	14,212
Loans settled in purchase of partnership	0	988
Financed OREO	750	3,400

16. Common Stock Dividend

The Company declared one-percent (1%) common stock dividends during each of the four quarters ended December 31, 2011, September 30, 2011, June 30, 2011, and March 31, 2011. All 1% stock dividends were considered "small stock dividends" resulting in a transfer between retained earnings and common stock an amount equal to the number of shares issued in the stock dividend multiplied by the stock's closing price at the date of declaration. Other than for earnings-per-share calculations, shares issued for the stock dividend have been treated prospectively for financial reporting purposes. For purposes of earnings per share calculations, the Company's weighted average shares outstanding and potentially dilutive shares used in the computation of earnings per share have been restated after giving retroactive effect to a 1% stock dividend to shareholders for all periods presented.

The Company declared one-percent (1%) common stock dividends during each of the four quarters ended December 31, 2010, September 30, 2010, June 30, 2010, and March 31, 2010. All 1% stock dividends were considered "small stock dividends" resulting in a transfer between retained earnings and common stock an amount equal to the number of shares issued in the stock dividend multiplied by the stock's closing price at the date of declaration. Other than for earnings-per-share calculations, shares issued for the stock dividend have been treated prospectively for financial reporting purposes. For purposes of earnings per share calculations, the Company's weighted average shares outstanding and potentially dilutive shares used in the computation of earnings per share have been restated after giving retroactive effect to a 1% stock dividend to shareholders for all periods presented.

17. Net (Loss) Income Per Share

The following table provides a reconciliation of the numerator and the denominator of the basic EPS computation with the numerator and the denominator of the diluted EPS computation. (Weighted average shares have been adjusted to give retroactive recognition for the 1% stock dividend for each of the quarters since the third quarter ended September 30, 2008):

<i>(In thousands, except earnings per share data)</i>	Years Ended December 31,	
	2011	2010
Net (loss) income available to common shareholders	\$(10,812)	\$(4,439)
Weighted average shares outstanding	13,532	13,532
Add: dilutive effect of stock options	0	0
Weighted average shares outstanding adjusted for potential dilution	13,532	13,532
Basic (loss) earnings per share	\$(0.80)	\$(0.33)
Diluted (loss) earnings per share	\$(0.80)	\$(0.33)
Anti-dilutive shares excluded from earnings per share calculation	155	219

18. Other Comprehensive (Loss) Income

The following table provides a reconciliation of the amounts included in comprehensive income:

<i>(In thousands)</i>	Years Ended December 31,	
	2011	2010
Unrealized (loss) gain on available-for-sale securities:		
Unrealized (loss) gain on sale securities – net of income tax (benefit) of (\$156) and \$1,367	\$(235)	\$2,051
Less: Reclassification adjustment for loss (gain) on sale of available-for-sale securities included in net income - net of income tax (benefit) of \$(4) and (\$27)	(7)	(41)
Net unrealized (loss) gain on available-for-sale securities - net income tax (benefit) of (\$152) and \$1,340	\$(228)	\$2,010
Previously unrecognized past service costs of employee benefit plans – net of tax (benefit) (\$56) and (\$108)	(\$75)	(\$163)
Total other comprehensive income (loss)	\$(303)	\$1,847

19. Common Stock Repurchase Plan

On May 16, 2007, the Company's Board of Directors approved a plan to repurchase, as conditions warrant, up to 701,129 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.

As a condition of the Written Agreement entered into with the Federal Reserve Bank of San Francisco (FRB) on May 23, 2010, and the Order entered into with the California Department of Financial Institutions (DFI) on May 17, 2010, the Company may not repurchase any of its common stock without prior approval of the FRB and the DFI. The Company did not repurchase any common shares during the year ended December 31, 2011 or 2010.

20. Goodwill and Intangible Assets

At December 31, 2011 the Company had \$4.5 million of goodwill, \$447,000 of core deposit intangibles, and \$106,000 of other identified intangible assets which were recorded in connection with various business combinations and purchases. The following table summarizes the carrying value of those assets at December 31, 2011 and 2010.

(in 000's)	December 31, 2011	December 31, 2010
Goodwill	\$4,488	\$5,977
Core deposit intangible assets	447	966
Other intangible assets	106	243
Total goodwill and intangible assets	\$5,041	\$7,186

Core deposit intangibles and other identified intangible assets are amortized over their useful lives, while goodwill is not amortized. The Company conducts periodic impairment analysis on goodwill and intangible assets and goodwill at least annually or more often as conditions require. The following table summarizes the amortization expense and impairment losses recorded on the Company's intangible assets and goodwill for the years ended December 2011 and 2010.

(in 000's)	2011	2010
Amortization expense - core deposit intangibles	\$482	\$563
Amortization expense - other intangibles	138	206
Total amortization expense	\$620	\$769
Impairment losses - core deposit intangibles	\$36	\$57
Impairment losses - other intangible assets	0	0
Impairment losses - goodwill	1,489	1,414
Total impairment losses	\$1,525	\$1,471

Goodwill: The largest component of goodwill is related to the Legacy merger (Campbell reporting unit) completed during February 2007 and totaled approximately \$2.9 million at December 31, 2011. The Company conducted its annual impairment testing of the goodwill related to the Campbell reporting unit effective March 31, 2011. Impairment testing for goodwill is a two-step process.

The first step in impairment testing is to identify potential impairment, which involves determining and comparing the fair value of the reporting unit with its carrying value. If the fair value of the reporting unit exceeds its carrying value, goodwill is not impaired. If the carrying value exceeds fair value, there is an indication of possible impairment and the second step is performed to determine the amount of the impairment, if any. The fair value determined in the step one testing was determined based on a discounted cash flow methodology using estimated market discount rates and projections of future cash flows for the Campbell reporting unit. In addition to projected cash flows, the Company also utilized other market metrics including industry multiples of earnings and price-to-book ratios to estimate what a market participant would pay for the operating unit in the current business environment. Determining the fair value involves a significant amount of judgment, including estimates of changes in revenue growth, changes in discount rates, competitive forces within the industry, and other specific industry and market valuation conditions. The 2010 impairment analysis was impacted by to a large degree by the current economic environment, including significant declines in interest rates, and depressed valuations within the financial industry. Based on the results of step one of the impairment analysis conducted during the first quarter of 2011, the Company concluded that the potential for goodwill impairment existed and, therefore, step-two testing was required to determine if there was goodwill impairment and the amount of goodwill that might be impaired, if any.

The Company utilized the services of an independent valuation firm to assist in determining the fair value of the Campbell reporting unit under step-two guidelines and whether there was goodwill impairment. The second step in impairment analysis compares the fair value of the Campbell reporting unit to the aggregate fair values of its individual assets, liabilities and identified intangibles. As a result of step-two impairment testing, the Company concluded that the goodwill related to the Campbell operating unit was impaired, and recognized a pre-tax and after-tax impairment loss of \$1,489,000 at June 30, 2011. Because the Legacy merger was a tax-free transaction, the Bank receives no benefit for the loss recorded during 2011.

As a result of impairment testing conducted during 2010, the Company recognized a pre-tax and after-tax impairment loss of \$1,414,000. As with the 2011 impairment loss, the Bank received no tax benefit for the loss recorded during 2010 because the Legacy merger was a tax-free transaction.

Core Deposit Intangibles: During the first quarter of 2011, the Company performed an annual impairment analysis of the core deposit intangible assets associated with the Legacy Bank merger completed during February 2007 (Campbell operating unit). The core deposit intangible asset, which totaled \$3.0 million at the time of merger, is being amortized over an estimated life of approximately seven years. The Company recognized \$295,000 and \$376,000 in amortization expense related to the Legacy operating unit during the years ended December 31, 2011 and 2010, respectively. At December 31, 2011, the carrying value of the core deposit intangible related to the Legacy Bank merger was \$12,000.

During the impairment analysis performed as of March 31, 2011, it was determined that the original deposits purchased from Legacy Bank during February 2007 continue to decline faster than originally anticipated. As a result of increased deposit runoff, particularly in noninterest-bearing checking accounts and savings accounts, the estimated value of the Campbell core deposit intangible was determined to be \$619,000 rather than the pre-adjustment carrying value of \$675,000. As a result of the impairment analysis, the Company recorded a pre-tax impairment loss of \$36,000 (\$21,000, net of tax) reflected as a component of noninterest expense for the year ended December 31, 2011.

As a result of impairment testing of core deposit intangible assets related to the Campbell operating unit conducted during the first quarter of 2010, the Company recorded a pre-tax impairment loss of \$57,000 (\$33,000, net of tax) reflected as a component of noninterest expense for the year ended December 31, 2010.

Other Intangible Assets: During November 2007, the Company purchased the recurring contractual revenue stream and certain fixed assets from ICG Financial, LLC. Additionally, the Company hired all but one of the former employees of ICG Financial, LLC and its subsidiaries. The total purchase price was \$414,000 including \$378,000 for the recurring revenue stream and \$36,000 for the fixed assets. As a department of the Bank, USB Financial Services provides wealth management, employee benefit, insurance and loan products, as well as consulting services for a variety of clients, utilizing employees hired from ICG Financial LLC. The original capitalized cost of \$378,000 for the recurring revenue stream was amortized over a period of approximately three years, and was fully amortized at December 31, 2010.

21. Parent Company Only Financial Statements

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

United Security Bancshares – (parent only) Balance Sheets - December 31, 2011 and 2010 (000's)	2011	2010
Assets		
Cash and equivalents	\$16	\$41
Investment in bank subsidiary	72,383	85,054
Investment in bank stock	24	89
Other assets	515	1,018
Total assets	<u>\$72,938</u>	<u>\$86,202</u>
Liabilities & Shareholders' Equity		
Liabilities:		
Junior subordinated debt securities (at fair value) 12/31/07)	\$9,027	\$10,646
Accrued interest payable	8	0
Deferred taxes	1,594	2,166
Other liabilities	136	120
Total liabilities	<u>10,765</u>	<u>12,932</u>
Shareholders' Equity:		
Common stock, no par value 20,000,000 shares authorized, 13,531,832 and 13,003,840 issued and outstanding, in 2011 and 2010	41,435	39,869
Retained earnings	21,447	33,807
Accumulated other comprehensive loss	(709)	(406)
Total shareholders' equity	<u>62,173</u>	<u>73,270</u>
Total liabilities and shareholders' equity	<u>\$72,938</u>	<u>\$86,202</u>

United Security Bancshares – (parent only)	Years ended December 31,	
Income Statements		
<i>(In thousands)</i>	2011	2010
Income		
Gain on fair value option of financial assets	1,863	316
Total income	1,863	316
Expense		
Interest expense	248	251
Other expense	136	547
Total expense	384	798
(Loss) income before taxes and equity in undistributed income of subsidiary	1,479	(482)
Income tax (benefit) expense	(127)	(198)
Deficit in undistributed income of subsidiary	(12,418)	(4,155)
Net (Loss) Income	<u>\$(10,812)</u>	<u>\$(4,439)</u>

United Security Bancshares – (parent only)	Years ended December 31,	
Statement of Cash Flows		
<i>(In thousands)</i>	2011	2010
Cash Flows From Operating Activities		
Net (loss) income	\$(10,812)	\$(4,439)
Adjustments to reconcile net (loss) income to cash provided by operating activities:		
Deficit (equity) in undistributed income of subsidiary	12,418	4,155
Deferred taxes	(572)	130
Write-down of other investments	0	355
Loss on sale of investment in bank stock	2	0
Gain on fair value option of financial liability		
Net change in other assets/liabilities	548	61
Net cash (used in) provided by operating activities	(37)	
Cash Flows From Investing Activities		
Investment in bank stock	0	0
Proceeds from sale of investment in title company	0	0
Net cash provided by (used in) investing activities	0	0
Cash Flows From Financing Activities		
Proceeds from sale investment in bank stock	12	0
Proceeds from note payable	0	75
Net cash provided by (used in) financing activities	12	75
Net increase (decrease) in cash and cash equivalents	(25)	21
Cash and cash equivalents at beginning of year	41	20
Cash and cash equivalents at end of year	<u>\$16</u>	<u>\$41</u>
Supplemental cash flow disclosures		
Noncash financing activities:		
Dividends declared not paid	<u>\$0</u>	<u>\$0</u>

22. Subsequent Events

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

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.

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 \$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.)*

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.
- 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.
- 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.

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.

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.

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.

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.

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 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.

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.

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.

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.

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).

<i>(in thousands except per share data and ratios)</i>	2011	2010	2009	2008	2007
Selected Financial Ratios:					
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%

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

<i>(Dollars in thousands)</i>	2011			2010		
	Average Balance	Interest	Yield/Rate	Average Balance	Interest	Yield/Rate
Assets:						
Interest-earning assets:						
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%
Total interest-earning assets	556,281	\$27,940	5.02%	609,845	\$32,490	5.33%
Allowance for credit losses	(15,021)			(13,825)		
Noninterest-bearing assets:						
Cash and due from banks	21,746			16,815		
Premises and equipment, net	12,831			12,950		
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	<u>\$2,964</u>	<u>0.73%</u>	491,096	<u>\$4,589</u>	<u>0.93%</u>
Noninterest-bearing liabilities:						
Noninterest-bearing	179,239			133,458		
Accrued interest payable	196			318		
Other liabilities	<u>5,304</u>			<u>4,556</u>		
Total average liabilities	589,915			629,428		
Total average shareholders' equity	<u>68,189</u>			<u>78,259</u>		
Total average liabilities and Shareholders' equity	<u>\$658,104</u>			<u>\$707,687</u>		
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			<u>4.49%</u>			<u>4.58%</u>

(1) Loan amounts include nonaccrual loans, but the related interest income has been included only if collected for the period prior to the loan being placed on a nonaccrual basis. Loan interest income includes loan 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

<i>(In thousands)</i>	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
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.

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:

<i>(In thousands)</i>	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
Shared appreciation income	0	0	0
Other	1,029	602	427
Total	<u>\$6,877</u>	<u>\$5,939</u>	<u>\$938</u>

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.

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 it 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:

<i>(Dollars in thousands)</i>	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%
Total	30,778	5.53%	\$29,020	4.76%

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.

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.

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								
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
Total Loans	\$408,715	100.0%	\$441,691	100.0%	\$508,573	100.0%	\$544,551	100.0%	\$592,795	100.0%

Loan volume continues to be greatest in what has historically been the Bank's primary lending emphasis: commercial, real estate mortgage, and construction lending. 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.

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:

<i>(In thousands)</i>	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	<u>\$168,047</u>	<u>\$206,327</u>	<u>\$34,340</u>	<u>\$408,715</u>

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:

<i>(In thousands)</i>	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	<u>154,700</u>	<u>202,151</u>	<u>33,766</u>	<u>390,617</u>
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	<u>12,381</u>	<u>4,632</u>	<u>1,085</u>	<u>18,098</u>
Total Loans	<u>\$167,081</u>	<u>\$206,783</u>	<u>\$34,851</u>	<u>\$408,715</u>

Securities

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

<i>(In thousands)</i>	December 31, 2011				December 31, 2010			
	Amortized Cost	Gross		Fair Value (Carrying Amount)	Amortized Cost	Gross		Fair Value (Carrying Amount)
		Unrealized Gains	Unrealized Losses			Unrealized Gains	Unrealized Losses	
<u>Available-for-sale:</u>								
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	<u>\$38,928</u>	<u>\$1,802</u>	<u>\$(2,272)</u>	<u>\$38,458</u>	<u>\$51,644</u>	<u>\$1,855</u>	<u>\$(1,996)</u>	<u>\$51,503</u>

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.

<i>(Dollars in thousands)</i>	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	<u>\$1,515</u>	<u>1.75%</u>	<u>\$8,133</u>	<u>1.47%</u>	<u>\$10,076</u>	<u>4.76%</u>	<u>\$18,734</u>	<u>5.41%</u>	<u>\$38,458</u>	<u>4.27%</u>

(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 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:

<i>(In thousands)</i>	December 31,			Change during Year	
	2011	2010	2009	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)

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:

<i>(Dollars in thousands)</i>	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.

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:

<i>(Dollars in thousands)</i>	December 31,		
	2011	2010	2009
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	<u>\$0</u>	<u>\$32,000</u>	<u>\$40,000</u>
Average ending interest rate – total	<u>0%</u>	<u>0.35%</u>	<u>0.86%</u>
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	<u>\$22,014</u>	<u>\$35,181</u>	<u>\$99,877</u>
Average interest rate – total	<u>0.46%</u>	<u>0.69%</u>	<u>0.80%</u>
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	<u>\$32,000</u>	<u>\$39,000</u>	<u>\$161,230</u>

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.

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):

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	<u>166,426</u>	<u>159,224</u>	<u>167,930</u>	<u>188,207</u>	<u>188,826</u>
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	<u>144,747</u>	<u>157,781</u>	<u>165,629</u>	<u>130,856</u>	<u>135,252</u>
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	<u>11,282</u>	<u>12,891</u>	<u>18,191</u>	<u>20,782</u>	<u>18,171</u>
11 Total Lease Financing	49	305	706	1,595	3,323
Total Loans	<u>\$408,715</u>	<u>\$441,691</u>	<u>\$508,573</u>	<u>\$544,551</u>	<u>\$592,795</u>

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.

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.

	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.

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.

(in 000's)	Balance December 31, 2011	Allowance December 31, 2011	Balance December 31, 2010	Allowance December 31, 2010	Balance December 31, 2009	Allowance December 31, 2009
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
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	<u>\$31,882</u>	<u>\$1,254</u>	<u>\$50,998</u>	<u>\$11,326</u>	<u>\$53,794</u>	<u>\$7,973</u>

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.

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.

<i>(in thousands)</i>	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	<u>\$19,050</u>	<u>\$7,225</u>	<u>\$11,827</u>

<i>(in thousands)</i>	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
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	<u>\$24,934</u>	<u>\$12,380</u>	<u>\$12,554</u>

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.

<i>(in thousands)</i>	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
Total Special Mention Loans	<u>\$11,603</u>	<u>\$24,645</u>

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.

<i>(Dollars in thousands)</i>	December 31,				
	2011	2010	2009	2008	2007
Total loans outstanding at end of period before deducting allowances for credit losses	<u>\$408,714</u>	<u>\$441,045</u>	<u>\$507,709</u>	<u>\$543,317</u>	<u>\$591,056</u>
Average net loans outstanding during period	<u>\$424,961</u>	<u>\$490,421</u>	<u>\$534,830</u>	<u>\$582,500</u>	<u>\$575,448</u>
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	<u>(17,294)</u>	<u>(11,936)</u>	<u>(10,145)</u>	<u>(5,545)</u>	<u>(4,493)</u>
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	3.34%	3.75%	2.96%	2.12%	1.26%
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.

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.

(Dollars in thousands)	2011		2010		2009		2008		2007	
	Allowance for Credit	% of								
	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)	December 31,				
	2011	2010	2009	2008	2007
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

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.

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

(Dollars in thousands, except footnote)	December 31,				
	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
<u>Nonaccrual Loans (in 000's):</u>					
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)

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.

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.

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.

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;
- 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
- 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.

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	Bank		
	Actual	Actual	Minimum	Regulatory
	Capital Ratios	Capital Ratios	Capital Ratios	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%

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.

Corporate Data

UNITED SECURITY BANCSHARES

Board of Directors	Management	Management (cont.)	Management (cont.)
Dennis R. Woods <i>Chairman of the Board</i>	Dennis R. Woods <i>President and Chief Executive Officer</i>	Leonard Perez <i>Vice President and Commercial Loan Officer</i>	Stasia Szpor <i>Vice President and Controller</i>
Ronnie D. Miller <i>Lead Director</i>	Kenneth L. Donahue <i>Executive Vice President and Chief Administrative Officer</i>	Thomas Ray <i>Vice President and Branch Manager, Campbell Office</i>	Daniel Esptein <i>Vice President and Commercial Credit Administrator</i>
Robert G. Bitter, PHARM. D. <i>Secretary of the Board</i>	Karl L. Miller <i>Senior Vice President and Chief Credit Officer</i>	Porsche A. Saunders <i>Vice President and R/E Construction Loan Manager</i>	Tanya Iacono <i>Vice President and Commercial Loan Officer</i>
Stanley J. Cavalla <i>Director</i>	David L. Eytcheson <i>Senior Vice President and Chief Operating Officer</i>	Ronald N. Steager <i>Vice President and R/E Construction Loan Officer</i>	Directors Emeritus
Tom Ellithorpe <i>Director</i>	Richard B. Shupe <i>Senior Vice President and Chief Financial Officer</i>	Paul N. Thaxter <i>Vice President and Branch Manager, Main Office</i>	William J. Asbury, D.D.S. M.S. W. Gerald Flanagan Jerry Greer
R. Todd Henry <i>Director</i>	Randy E. House <i>Vice President and Credit Administrator</i>	Kim Bledsoe <i>Vice President and Risk Manager</i>	Elbert Guyette R. Kent Kunz Gerald McIntrye
Robert M. Mochizuki, M.D. <i>Director</i>	Shyam Iyer <i>Vice President and Credit Administrator</i>	Paul Gottlieb <i>Group Benefits Manager</i>	Joseph Petkewich Martha Sanford O'Neal Sutton III
Walter Reinhard <i>Director</i>	Stanley G. Cornwell <i>Vice President and Agricultural Loan Officer</i>	Karyn D. Reynolds <i>Vice President and Manager- Loan Service Center</i>	Bobbi Thomason Les Workman Samson Zarnegar
John Terzian <i>Director</i>	Rosemary McCave <i>Vice President and Branch Manager – N. First Office</i>	Susan J. Robertson <i>Vice President and Data Processing Manager</i>	William H. Ziering, M.D
Michael T. Woolf, DDS <i>Director</i>	Michael McFadden <i>Vice President and Commercial Loan Officer</i>	Ellie M. Rosenberg <i>Vice President and Human Resources Director</i>	

Transfer Agent and

Registrar of Common Stock

Wells Fargo Shareowner Services
161 North Concord Exchange
South St. Paul, MN 55075-1139
(800) 468-9716

STOCK INFORMATION

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42605 Moonridge Rd.
Big Bear Lake, CA 92315
(800) 288-2811

Hill Thompson Magid & Co.
15 Exchange Place
P.O. Box 1688 - NOL Center
Jersey City, NJ 07302
(800) 631-3083

Howe Barnes Hoeffler & Arnett, Inc.
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18th Floor
San Francisco, CA 94105
(415) 362-7111

United Security Bank Locations

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2151 W. Shaw Avenue
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(559) 225-0101
FAX (559) 248-4929

San Joaquin Branch

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San Joaquin, CA 93660
(559) 693-4332
FAX (559) 693-2598

Taft Branch

523 Cascade Place
Taft, CA 93268
(661) 763-5151
FAX (661) 765-4340

Administrative Offices

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Fresno, CA 93721
(559) 248-4944
FAX (559) 221-8593

First & Herndon Branch

7088 N. First Street
Fresno, CA 93720
(559) 248-4949
FAX (559) 249-4939

Firebaugh Branch

1067 "O" Street
Firebaugh, CA 93622
(559) 659-2077
FAX (559) 659-1037

Bakersfield Branch

3404 Coffee Road
Bakersfield, CA 93308
(661) 588-2265
FAX (661) 588-2773

USB Financial Services

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(559) 490-6203
FAX (559) 490-6211

Oakhurst Branch

40074 Highway 49
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FAX (559) 683-3879

Coalinga Branch

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(559) 935-0862
FAX (559) 935-2151

Campbell Branch

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Campbell, CA 95008
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FAX (408) 341-1022

Caruthers Branch

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Caruthers, CA 93609
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FAX (559) 864-8659

Convention Center Branch

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Real Estate Construction Dept.

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