SIERRA BANCORP
Form 10-K
March 14, 2018

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

Annual Report Pursuant to Section 13 or 15(d)

of the Securities Exchange Act of 1934

For the fiscal year ended December 31, 2017

Commission file number: 000-33063

SIERRA BANCORP

(Exact name of registrant as specified in its charter)

California	33-0937517
(State of incorporation)	(I.R.S. Employer Identification No.)

86 North Main Street, Porterville, California	93257
(Address of principal executive offices)	(Zip Code)

(559) 782-4900

Registrant's telephone number, including area code

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Name of each exchange on which registered
Common Stock, No Par Value	The NASDAQ Stock Market LLC (NASDAQ Global Select Market)

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

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

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes No

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

Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes No

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

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

Large accelerated filer Smaller reporting company Accelerated filer

Non-accelerated filer (Do not check if a smaller reporting company) Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards pursuant to Section 13(a) of the Exchange Act.

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

As of June 30, 2017, the last business day of the registrant's most recently completed second fiscal quarter, the aggregate market value of the voting stock held by non-affiliates of the registrant was approximately $298 million, based on the closing price reported to the registrant on that date of $24.55 per share. Shares of Common Stock held by each officer and director and each person or control group owning more than ten percent of the outstanding

Common Stock have been excluded in that such persons may be deemed to be affiliates. This determination of affiliate status is not necessarily a conclusive determination for other purposes.

The number of shares of common stock of the registrant outstanding as of March 1, 2018 was 15,234,980.

Documents Incorporated by Reference: Portions of the definitive proxy statement for the 2018 Annual Meeting of Shareholders to be filed with the Securities and Exchange Commission pursuant to SEC Regulation 14A are incorporated by reference in Part III, Items 10-14.

TABLE OF CONTENTS

PART I

Item 1. Business

General

The Company

Sierra Bancorp (the "Company") is a California corporation headquartered in Porterville, California, and is a registered bank holding company under federal banking laws. The Company was formed to serve as the holding company for Bank of the Sierra (the "Bank"), and has been the Bank's sole shareholder since August 2001. The Company exists primarily for the purpose of holding the stock of the Bank and of such other subsidiaries it may acquire or establish. As of December 31, 2017, the Company's only other subsidiaries were Sierra Statutory Trust II, Sierra Capital Trust III, and Coast Bancorp Statutory Trust II, which were formed solely to facilitate the issuance of capital trust pass-through securities ("TRUPS"). Pursuant to the Financial Accounting Standards Board ("FASB") standard on the consolidation of variable interest entities, these trusts are not reflected on a consolidated basis in the financial statements of the Company. References herein to the "Company" include Sierra Bancorp and its consolidated subsidiary, the Bank, unless the context indicates otherwise. At December 31, 2017, the Company had consolidated assets of $2.340 billion (including gross loans of $1.558 billion), liabilities totaling $2.084 billion (including deposits of $1.988 billion), and shareholders' equity of $256 million. The Company's liabilities include $35 million in debt obligations due to its trust subsidiaries, related to TRUPS issued by those entities.

The Bank

Bank of the Sierra, a California state-chartered bank headquartered in Porterville, California, offers a full range of retail and commercial banking services via branch offices located throughout California's South San Joaquin Valley, the Central Coast, Ventura County, and neighboring communities. The Bank was incorporated in September 1977, and opened for business in January 1978 as a one-branch bank with $1.5 million in capital. Our growth in the ensuing years has largely been organic in nature, but includes four whole-bank acquisitions: Sierra National Bank in 2000, Santa Clara Valley Bank in 2014, Coast National Bank in 2016, and Ojai Community Bank in October 2017. See Note 21 to the consolidated financial statements, Business Combinations, for details on our most recent acquisitions.

The Ojai Community Bank acquisition included branches in Ojai, Ventura, Santa Paula, and Santa Barbara, California, and we consolidated our Oxnard loan production office into the Ventura branch shortly after the acquisition. Furthermore, we acquired a branch in Woodlake, California in November 2017, opened de novo branches in Bakersfield and Pismo Beach earlier in the year, and relocated our Paso Robles branch in the first quarter of 2017. We also closed our Fresno Herndon branch in October 2017, but intend to open another Fresno branch on Palm Avenue in the first half of 2018 within close proximity of the discontinued office. With our latest acquisitions and branching activity, as of December 31, 2017 the Bank operated 39 full-service branches in the following California locations:

Porterville:	Administrative Headquarters 86 North Main Street	Main Office 90 North Main Street	West Olive Branch 1498 West Olive Avenue
Arroyo Grande:	Arroyo Grande Office 1360 East Grand Avenue		

Atascadero:	Atascadero Office 7315 El Camino Real		
Bakersfield:	Bakersfield California Office 4456 California Ave	Bakersfield Riverlakes Office 4060 Coffee Road	Bakersfield East Hills Office 2501 Mt. Vernon Avenue
	Bakersfield Ming Office 8500 Ming Avenue		

1

California City:	California City Office	
	8031 California City Blvd.	
Clovis:	Clovis Office	
	1835 East Shaw Avenue	
Delano:	Delano Office	
	1126 Main Street	
Dinuba:	Dinuba Office	
	401 East Tulare Street	
Exeter:	Exeter Office	
	1103 West Visalia Road	
Farmersville:	Farmersville Office	
	400 West Visalia Road	
Fillmore:	Fillmore Office	
	527 Sespe Avenue	
Fresno:	Fresno Shaw Office	Fresno Sunnyside Office
	636 East Shaw Avenue	5775 E. Kings Canyon Rd.
Hanford:	Hanford Office	
	427 West Lacey Boulevard	
Lindsay:	Lindsay Office	
	142 South Mirage Avenue	
Ojai:	Ojai Office	
	402 W. Ojai Avenue	
Paso Robles:	Paso Robles Office	
	1207 Spring Street	
Pismo Beach:	Pismo Beach Office	
	1401 Dolliver Street	
Reedley:	Reedley Office	
	1095 W. Manning Street	
San Luis Obispo:	San Luis Obispo Office	
	500 Marsh Street	
Sanger:	Sanger Office	
	1500 7th Street	
Santa Barbara:	Santa Barbara Office	

	21 E. Carrillo Street	
Santa Clarita:	Santa Clarita Office	
	26328 Citrus Street	
Santa Paula:	Santa Paula Office	Santa Paula Harvard Office
	901 E. Main Street	537 West Harvard Boulevard

Selma:	Selma Office	
	2446 McCall Avenue	
Tehachapi:	Tehachapi Downtown Office	Tehachapi Old Town Office
	224 West “F” Street	21000 Mission Street
Three Rivers:	Three Rivers Office	
	40884 Sierra Drive	
Tulare:	Tulare Office	Tulare Prosperity Office
	246 East Tulare Avenue	1430 E Prosperity Avenue
Ventura:	Ventura Office	
	89 S. California Street	
Visalia:	Visalia Mooney Office	Visalia Downtown Office
	2515 South Mooney Blvd.	128 East Main Street
Woodlake:	Woodlake Office	
	232 N. Valencia Boulevard	

Additional branching activity has occurred in or is planned for the first part of 2018, including the consolidation of Ojai Community Bank’s former Santa Paula branch (the Santa Paula Harvard Office) into our Santa Paula Main Street office in early January, the opening of a branch on Palm Avenue in Fresno in the second quarter, and the acquisition of Community Bank of Santa Maria’s Lompoc branch in the second quarter (see “Recent Developments” below). Complementing the Bank’s stand-alone offices are specialized lending units which include our real estate industries center, an agricultural credit center, and an SBA lending unit. We also have ATMs at all branch locations and six different non-branch locations. Furthermore, the Bank is a member of the Allpoint network, which provides our deposit customers with surcharge-free access to over 43,000 ATMs across the nation and another 12,000 ATMs in foreign countries, and customers have access to electronic point-of-sale payment alternatives nationwide via the Pulse network. To ensure that account access preferences are addressed for all customers, we provide the following options: an internet branch which provides the ability to open deposit accounts online; an online banking option with bill-pay and mobile banking capabilities, including mobile check deposit; a customer service center that is accessible by toll-free telephone during business hours; and an automated telephone banking system that is usually accessible 24 hours a day, seven days a week. We offer a variety of other banking products and services to complement and support our lending and deposit products, including remote deposit capture and payroll services for business customers.

Our chief products and services relate to extending loans and accepting deposits. Our lending activities include real estate, commercial (including small business), mortgage warehouse, agricultural, and consumer loans. The bulk of our real estate loans are secured by commercial, professional office and agricultural properties, but we also offer a complete line of construction loans for residential and commercial development, permanent mortgage loans, land acquisition and development loans, and multifamily credit facilities. Secondary market services for residential mortgage loans are provided through the Bank’s affiliations with Freddie Mac, Fannie Mae and certain non-governmental institutions. As noted above, gross loans totaled $1.558 billion at December 31, 2017, and the percentage of our total loan and lease portfolio for each of the principal types of credit we extend was as follows: (i) loans secured by real estate (78.7%); (ii) agricultural production loans (3.0%); (iii) commercial and industrial loans and leases (including SBA loans and direct finance leases) (8.7%); (iv) mortgage warehouse loans (8.9%); and (v) consumer loans (0.7%). Interest, fees, and other income on real-estate secured loans, which is by far the largest segment of our portfolio, totaled $53.3 million, or 55% of net interest plus other income in 2017, and $42.1 million, or 50% of net interest plus other income in 2016.

In addition to loans, we offer a wide range of deposit products and services for individuals and businesses including checking accounts, savings accounts, money market demand accounts, time deposits, retirement accounts, and sweep accounts. The Bank's deposit accounts are insured by the Federal Deposit Insurance Corporation (the "FDIC") up to maximum insurable amounts. We attract deposits throughout our market area via referrals from other customers, direct-mail campaigns, a customer-oriented product mix, competitive pricing, convenient locations, drive-through banking, and by offering various other delivery channels. We strive to retain our deposit customers by providing a consistently high level of service. At December 31, 2017, the consolidated Company had 118,700 deposit accounts totaling $1.988 billion, compared to 107,500 deposit accounts totaling $1.695 billion at December 31, 2016.

We have not engaged in any material research activities related to the development of new products or services during the last two fiscal years. However, our officers and employees are continually searching for ways to increase public convenience, enhance customer access to payment systems, and enable us to improve our competitive position. The cost to the Bank for these development, operations, and marketing activities cannot be calculated with any degree of certainty. We hold no patents or licenses (other than licenses required by bank regulatory agencies), franchises, or concessions. Our business has a modest seasonal component due to the heavy agricultural orientation of the Central Valley, but as our branches in more metropolitan areas have expanded we have become less reliant on the agriculture-related base. We are not dependent on a single customer or group of related customers for a material portion of our core deposits, but our time deposit balances at December 31, 2017 include $120 million in deposits from the State of California, comprising 6% of total deposits. Furthermore, for loans we have what could be considered to be industry concentrations in loans to the dairy industry (8% of total loans), and credit extended to mortgage companies in the form of mortgage warehouse loans (9% of total loans). Our efforts to comply with government and regulatory mandates on consumer protection and privacy, anti-terrorism, and other initiatives have resulted in significant ongoing expense to the Bank, including compliance staffing costs and other expenses associated with compliance-related software. However, as far as can be determined there has been no material effect upon our capital expenditures, earnings, or competitive position as a result of environmental regulation at the Federal, state, or local level. The Company is not involved with chemicals or toxins that might have an adverse effect on the environment, thus its primary exposure to environmental legislation is through lending activities. The Company's lending procedures include steps to identify and monitor this exposure in an effort to avoid any related loss or liability.

Recent Developments

On October 1, 2017, the Company completed its acquisition of OCB Bancorp, parent company to Ojai Community Bank (collectively referred to herein as "Ojai"), and the conversion of Ojai's core banking system to Bank of the Sierra's core system took place on November 3, 2017. Furthermore, on November 3, 2017 the Company acquired the Woodlake branch of Citizen's Business Bank. See Note 21 to the consolidated financial statements, Business Combinations, for more detailed information on these acquisitions.

On January 23, 2018, the Bank announced that it has entered into an agreement with Community Bank of Santa Maria to acquire its branch located in Lompoc, California (Santa Barbara County). The transaction is expected to close in the second quarter of 2018, subject to the receipt of all required regulatory approvals. Subsequent to the acquisition, the Lompoc branch will operate as a full-service branch of Bank of the Sierra. Lompoc branch deposits totaled $39 million at December 31, 2017, consisting largely of non-maturity deposits. However, some of those deposits are excluded pursuant to the terms of the acquisition agreement and it is expected that the amount ultimately acquired could be closer to $35 million. The acquisition agreement also contemplates that Bank of the Sierra will purchase the Lompoc branch building, the real property on which the building is located, and certain other equipment and fixed assets at their aggregate fair value of $1.7 million.

Recent Accounting Pronouncements

Information on recent accounting pronouncements is contained in Note 2 to the consolidated financial statements.

Competition

The banking business in California is generally highly competitive, including in our market areas. Continued consolidation within the banking industry has heightened competition in recent periods, following on the heels of a relatively large number of FDIC-assisted takeovers of failed banks and other acquisitions of troubled financial institutions in the aftermath of the Great Recession. There are also a number of unregulated companies competing for business in our markets, with financial products targeted at profitable customer segments. Many of those companies are able to compete across geographic boundaries and provide meaningful alternatives to banking products and services. These competitive trends are likely to continue.

With respect to commercial bank competitors, our business is dominated by a relatively small number of major banks that operate a large number of offices within our geographic footprint. Based on June 30, 2017 FDIC combined market share data for the 30 cities within which the Company currently maintains branches, the largest portion of deposits belongs to Wells Fargo Bank with 21.7% of total combined deposits, followed by Bank of America (17.3%), JPMorgan Chase (10.4%), Union Bank (8.7%), and Rabobank (5.5%). Bank of the Sierra ranks sixth on the 2017 market share list with 4.7% of total deposits (including Ojai Community Bank deposits). In Tulare County, however, where the Bank was originally formed, we rank first for deposit market share with 20.0% of total deposits at June 30, 2017, and had the largest number of branch locations (12, including our online branch). With the addition of the Woodlake branch, which is not included in the numbers above, Bank of the Sierra now operates 13 branches in Tulare County and enjoys an even higher market share percentage. The larger banks noted above have, among other advantages, the ability to finance wide-ranging advertising campaigns and to allocate their resources to regions of highest yield and demand. They can also offer certain services that we do not provide directly but may offer indirectly through correspondent institutions, and by virtue of their greater capitalization those banks have legal lending limits that are substantially higher than ours. For loan customers whose needs exceed our legal lending limits, we typically arrange for the sale, or participation, of some of the balances to financial institutions that are not within our geographic footprint.

In addition to other banks our competitors include savings institutions, credit unions, and numerous non-banking institutions such as finance companies, leasing companies, insurance companies, brokerage firms, asset management groups, mortgage banking firms and internet companies. Innovative technologies have lowered traditional barriers of entry and enabled many of these companies to offer services that were previously considered traditional banking products, and we have witnessed increased competition from companies that circumvent the banking system by facilitating payments via the internet, mobile devices, prepaid cards, and other means.

Strong competition for deposits and loans among financial institutions and non-banks alike affects interest rates and terms on which financial products are offered to customers. Mergers between financial institutions have created additional pressures within the financial services industry to streamline operations, reduce expenses, and increase revenues in order to remain competitive. Competition is also impacted by federal and state interstate banking laws which permit banking organizations to expand into other states. The relatively large California market has been particularly attractive to out-of-state institutions.

For years we have countered rising competition by offering a broad array of products with flexibility in structure and terms that cannot always be matched by our competitors. We also offer our customers community-oriented, personalized service, and rely on local promotional activity and personal contact by our employees. As noted above, layered onto our traditional personal-contact banking philosophy are technology-driven initiatives that improve customer access and convenience.

Employees

As of December 31, 2017 the Company had 490 full-time and 86 part-time employees. On a full-time equivalent basis staffing stood at 560 at December 31, 2017, up from 479 at December 31, 2016.

Regulation and Supervision

Banks and bank holding companies are heavily regulated by federal and state laws and regulations. Most banking regulations are intended primarily for the protection of depositors and the deposit insurance fund and not for the benefit of shareholders. The following is a summary of certain statutes, regulations and regulatory guidance affecting the Company and the Bank. This summary is not intended to be a complete explanation of such statutes, regulations and guidance, all of which are subject to change in the future, nor does it fully address their effects and potential effects on the Company and the Bank.

Regulation of the Company Generally

The Company is a legal entity separate and distinct from the Bank and its other subsidiaries. As a bank holding company, the Company is regulated under the Bank Holding Company Act of 1956 (the "BHC Act"), and is subject to supervision, regulation and inspection by the Federal Reserve Board. The Company is also subject to certain provisions of the California Financial Code which are applicable to bank holding companies. In addition, the Company is under the jurisdiction of the SEC and is subject to the disclosure and regulatory requirements of the Securities Act of 1933 and the Securities Exchange Act of 1934, each administered by the SEC. The Company's common stock is listed on the NASDAQ Global Select market ("NASDAQ") with "BSRR" as its trading symbol, and the Company is subject to the rules of NASDAQ for listed companies.

The Company is a bank holding company within the meaning of the BHC Act and is registered as such with the Federal Reserve Board. A bank holding company is required to file annual reports and other information with the Federal Reserve regarding its business operations and those of its subsidiaries. In general, the BHC Act limits the business of bank holding companies to banking, managing or controlling banks and other activities that the Federal Reserve has determined to be so closely related to banking as to be a proper incident thereto, including securities brokerage services, investment advisory services, fiduciary services, and management advisory and data processing services, among others. A bank holding company that also qualifies as and elects to become a "financial holding company" may engage in a broader range of activities that are financial in nature or complementary to a financial activity (as determined by the Federal Reserve or Treasury regulations), such as securities underwriting and dealing, insurance underwriting and agency, and making merchant banking investments. The Company has not elected to become a financial holding company but may do so at some point in the future if deemed appropriate in view of opportunities or circumstances at the time.

The BHC Act requires the prior approval of the FRB for the direct or indirect acquisition of more than five percent of the voting shares of a commercial bank or its parent holding company. Acquisitions by the Bank are subject instead to the Bank Merger Act, which requires the prior approval of an acquiring bank's primary federal regulator for any merger with or acquisition of another bank. Acquisitions by both the Company and the Bank also require the prior approval of the California Department of Business Oversight (the "DBO") pursuant to the California Financial Code.

The Company and the Bank are deemed to be "affiliates" of each other and thus are subject to Sections 23A and 23B of the Federal Reserve Act as well as related Federal Reserve Regulation W which impose both quantitative and qualitative restrictions and limitations on transactions between affiliates. The Bank is also subject to laws and regulations requiring that all extensions of credit to our executive officers, directors, principal shareholders and related parties must, among other things, be made on substantially the same terms and follow credit underwriting procedures no less stringent than those prevailing at the time for comparable transactions with persons not related to the Bank.

Under certain conditions, the Federal Reserve has the authority to restrict the payment of cash dividends by a bank holding company as an unsafe and unsound banking practice, and may require a bank holding company to obtain the approval of the Federal Reserve prior to purchasing or redeeming its own equity securities. The Federal Reserve also has the authority to regulate the debt of bank holding companies.

A bank holding company is required to act as a source of financial and managerial strength for its subsidiary banks and must commit resources as necessary to support such subsidiaries. The Federal Reserve may require a bank holding company to contribute additional capital to an undercapitalized subsidiary bank and may disapprove of the holding company's payment of dividends to the shareholders in such circumstances.

Regulation of the Bank Generally

As a state chartered bank, the Bank is subject to broad federal regulation and oversight extending to all its operations by the FDIC and to state regulation by the DBO. The Bank is also subject to certain regulations of the Federal Reserve Board.

Capital Adequacy Requirements

The Company and the Bank are subject to the regulations of the Federal Reserve Board and the FDIC, respectively, governing capital adequacy. These agencies have adopted risk-based capital guidelines to provide a systematic ana

6

lytical framework that imposes regulatory capital requirements based on differences in risk profiles among banking organizations, considers off-balance sheet exposures in evaluating capital adequacy, and minimizes disincentives to holding liquid, low-risk assets. Capital levels, as measured by these standards, are also used to categorize financial institutions for purposes of certain prompt corrective action regulatory provisions.

Pursuant to the adoption of final rules implementing the Basel Committee on Banking Supervision's capital guidelines for all U.S. banks and bank holding companies with more than $500 million in assets, minimum regulatory requirements for both the quantity and quality of capital held by the Company and the Bank increased effective January 1, 2015. Furthermore, a capital class known as Common Equity Tier 1 capital was established in addition to Tier 1 capital and Tier 2 capital, and most financial institutions were given the option of a one-time election to continue to exclude accumulated other comprehensive income ("AOCI") from regulatory capital. The Company has exercised its option to exclude AOCI from regulatory capital. The final rules also increased capital requirements for certain categories of assets, including higher-risk construction and real estate loans, certain past-due or nonaccrual loans, and certain exposures related to securitizations. The final rules permanently grandfather non-qualifying capital instruments (such as trust preferred securities and cumulative perpetual preferred stock) issued before May 19, 2010 for inclusion in the Tier 1 capital of banking organizations with total consolidated assets of less than $15 billion at December 31, 2009, subject to a limit of 25% of Tier 1 capital. All of the Company's trust preferred securities were issued prior to that date, and they continue to qualify as Tier 1 capital.

Our Common Equity Tier 1 capital includes common stock, additional paid-in capital, and retained earnings, less the following: disallowed goodwill and intangibles, disallowed deferred tax assets, and any insufficient additional capital to cover the deductions. Tier 1 capital is generally defined as the sum of core capital elements, less the following: goodwill and other intangible assets, accumulated other comprehensive income, disallowed deferred tax assets, and certain other deductions. The following items are defined as core capital elements: (i) common shareholders' equity; (ii) qualifying non-cumulative perpetual preferred stock and related surplus (and, in the case of holding companies, senior perpetual preferred stock issued to the U.S. Treasury Department pursuant to the Troubled Asset Relief Program); (iii) minority interests in the equity accounts of consolidated subsidiaries; and (iv) "restricted" core capital elements (which include qualifying trust preferred securities) up to 25% of all core capital elements. Tier 2 capital includes the following supplemental capital elements: (i) allowance for loan and lease losses (but not more than 1.25% of an institution's risk-weighted assets); (ii) perpetual preferred stock and related surplus not qualifying as core capital; (iii) hybrid capital instruments, perpetual debt and mandatory convertible debt instruments; and, (iv) term subordinated debt and intermediate-term preferred stock and related surplus. The maximum amount of Tier 2 capital is capped at 100% of Tier 1 capital.

The final rules established a regulatory minimum of 4.5% for common equity Tier 1 capital to total risk weighted assets ("Common Equity Tier 1 RBC Ratio"), a minimum of 6.0% for Tier 1 capital to total risk weighted assets ("Tier 1 Risk-Based Capital Ratio" or "Tier 1 RBC Ratio"), a minimum of 8.0% for qualifying Tier 1 plus Tier 2 capital to total risk weighted assets ("Total Risk-Based Capital Ratio" or "Total RBC Ratio"), and a minimum of 4.0% for the Leverage Ratio, which is defined as Tier 1 capital to adjusted average assets (quarterly average assets less the disallowed capital items discussed above). In addition to the other minimum risk-based capital standards the final rules also require a Common Equity Tier 1 capital conservation buffer, which is being phased in over three years starting on January 1, 2016. The capital conservation buffer was 0.625% for 2016 and 1.25% for 2017. It increased to 1.875% for 2018 and will be fully phased in to 2.5% of risk-weighted assets beginning on January 1, 2019. At that point the buffer will effectively raise the minimum required Common Equity Tier 1 RBC Ratio to 7.0%, the Tier 1 RBC Ratio to 8.5%, and the Total RBC Ratio to 10.5%. Institutions that do not maintain the required capital buffer will become subject to progressively more stringent limitations on the percentage of earnings that can be paid out in dividends or used for stock repurchases, and on the payment of discretionary bonuses to executive management.

Based on our capital levels at December 31, 2017 and 2016, the Company and the Bank would have met all capital adequacy requirements under the Basel III Capital Rules on a fully phased-in basis. For more information on the Company's capital, see Part II, Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operation – Capital Resources. Risk-based capital ratio ("RBC") requirements are discussed in greater detail in the following section.

Prompt Corrective Action Provisions

Federal law requires each federal banking agency to take prompt corrective action to resolve the problems of insured financial institutions, including but not limited to those that fall below one or more of the prescribed minimum capital ratios. The federal banking agencies have by regulation defined the following five capital categories: “well capitalized” (Total RBC Ratio of 10%; Tier 1 RBC Ratio of 8%; Common Equity Tier 1 RBC Ratio of 6.5%; and Leverage Ratio of 5%); “adequately capitalized” (Total RBC Ratio of 8%; Tier 1 RBC Ratio of 6%; Common Equity Tier 1 RBC Ratio of 4.5%; and Leverage Ratio of 4%); “undercapitalized” (Total RBC Ratio of less than 8%; Tier 1 RBC Ratio of less than 6%; Common Equity Tier 1 RBC Ratio of less than 4.5%; or Leverage Ratio of less than 4%); “significantly undercapitalized” (Total RBC Ratio of less than 6%; Tier 1 RBC Ratio of less than 4%; Common Equity Tier 1 RBC Ratio of less than 3%; or Leverage Ratio less than 3%); and “critically undercapitalized” (tangible equity to total assets less than or equal to 2%). A bank may be treated as though it were in the next lower capital category if, after notice and the opportunity for a hearing, the appropriate federal agency finds an unsafe or unsound condition or practice merits a downgrade, but no bank may be treated as “critically undercapitalized” unless its actual tangible equity to assets ratio warrants such treatment. As of December 31, 2017 and 2016, both the Company and the Bank were deemed to be well capitalized for regulatory capital purposes.

At each successively lower capital category, an insured bank is subject to increased restrictions on its operations. For example, a bank is generally prohibited from paying management fees to any controlling persons or from making capital distributions if to do so would cause the bank to be “undercapitalized.” Asset growth and branching restrictions apply to undercapitalized banks, which are required to submit written capital restoration plans meeting specified requirements (including a guarantee by the parent holding company, if any). “Significantly undercapitalized” banks are subject to broad regulatory authority, including among other things capital directives, forced mergers, restrictions on the rates of interest they may pay on deposits, restrictions on asset growth and activities, and prohibitions on paying bonuses or increasing compensation to senior executive officers without FDIC approval. Even more severe restrictions apply to “critically undercapitalized” banks. Most importantly, except under limited circumstances, not later than 90 days after an insured bank becomes critically undercapitalized the appropriate federal banking agency is required to appoint a conservator or receiver for the bank.

In addition to measures taken under the prompt corrective action provisions, insured banks may be subject to potential actions by the federal regulators for unsafe or unsound practices in conducting their businesses or for violations of any law, rule, regulation or any condition imposed in writing by the agency or any written agreement with the agency. Enforcement actions may include the issuance of cease and desist orders, termination of insurance on deposits (in the case of a bank), the imposition of civil money penalties, the issuance of directives to increase capital, formal and informal agreements, or removal and prohibition orders against “institution-affiliated” parties.

Safety and Soundness Standards

The federal banking agencies have also adopted guidelines establishing safety and soundness standards for all insured depository institutions. Those guidelines relate to internal controls, information systems, internal audit systems, loan underwriting and documentation, compensation, and liquidity and interest rate exposure. In general, the standards are designed to assist the federal banking agencies in identifying and addressing problems at insured depository institutions before capital becomes impaired. If an institution fails to meet the requisite standards, the appropriate federal banking agency may require the institution to submit a compliance plan and could institute enforcement proceedings if an acceptable compliance plan is not submitted or followed.

The Dodd-Frank Wall Street Reform and Consumer Protection Act

Legislation and regulations enacted and implemented since 2008 in response to the U.S. economic downturn and financial industry instability continue to impact most institutions in the banking sector. Certain provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), which was enacted in 2010, are now effective and have been fully implemented, including revisions to the deposit insurance assessment base for FDIC insurance and a permanent increase in coverage to $250,000; the permissibility of paying interest on business checking accounts; the removal of barriers to interstate branching; and, required disclosures and shareholder advisory votes on executive compensation. Additional actions taken to implement Dodd-Frank provisions include (i) final capital rules, (ii) a final rule to implement the so called Volcker rule restrictions on certain proprietary trading and investment activities, and (iii) final rules and increased enforcement action by the Consumer Finance Protection Bureau (discussed further below in connection with consumer protection).

Some aspects of Dodd-Frank are still subject to rulemaking, making it difficult to anticipate the ultimate financial impact on the Company, its customers or the financial services industry more generally. However, many provisions of Dodd-Frank are already affecting our operations and expenses, including but not limited to changes in FDIC assessments, the permitted payment of interest on demand deposits, and enhanced compliance requirements. Some of the rules and regulations promulgated or yet to be promulgated under Dodd-Frank will apply directly only to institutions much larger than ours, but could indirectly impact smaller banks, either due to competitive influences or because certain required practices for larger institutions may subsequently become expected "best practices" for smaller institutions. We could see continued attention and resources devoted by the Company to ensure compliance with the statutory and regulatory requirements engendered by Dodd-Frank.

Tax Cuts and Jobs Act

On December 22, 2017, the Tax Cuts and Jobs Act (the "Act") was signed into law. The Act makes significant changes that impact corporate taxation, including the reduction of the maximum federal income tax rate for corporations from 35% to 21% and changes or limitations to certain tax deductions. The reduced tax rate will have a favorable impact on our tax expense beginning in 2018, and we anticipate that our blended marginal income tax rate will drop to 29.56% in 2018 from 42.05% in 2017. The tax rate reduction also resulted an adjustment to our deferred tax assets and liabilities to reflect their value to the Company at the lower federal tax rate of 21%, with such revaluation required in the period in which the legislation was enacted. Subsequent to a detailed analysis of our deferred tax assets and liabilities we reduced our net deferred tax asset by $2.710 million via a charge to our income tax provision, and our net deferred tax asset totaled $6.527 million at December 31, 2017.

Deposit Insurance

The Bank's deposits are insured up to maximum applicable limits under the Federal Deposit Insurance Act, and the Bank is subject to deposit insurance assessments to maintain the FDIC's Deposit Insurance Fund (the "DIF"). In October 2010, the FDIC adopted a revised restoration plan to ensure that the DIF's designated reserve ratio ("DRR") reaches 1.35% of insured deposits by September 30, 2020, the deadline mandated by the Dodd-Frank Act. In August 2016 the FDIC announced that the DIF reserve ratio had surpassed 1.15% as of June 30, 2016 and assessment rates for most institutions were adjusted downward, but institutions with $10 billion or more in assets were assessed a quarterly surcharge which will continue until the reserve ratio reaches the statutory minimum of 1.35%. Furthermore, the restoration plan proposed an increase in the DRR to 2% of estimated insured deposits as a long-term goal for the fund.

As noted above, the Dodd-Frank Act provided for a permanent increase in FDIC deposit insurance per depositor from $100,000 to $250,000 retroactive to January 1, 2008. Furthermore, effective in the second quarter of 2011, FDIC deposit insurance premium assessment rates were adjusted, and the assessment base was established as an institution's total assets less tangible equity. We are generally unable to control the amount of premiums that we are required to pay for FDIC deposit insurance. If there are additional bank or financial institution failures or if the FDIC otherwise determines, we may be required to pay higher FDIC premiums, which could have a material adverse effect on our earnings and/or on the value of, or market for, our common stock.

In addition to DIF assessments, banks must pay quarterly assessments that are applied to the retirement of Financing Corporation bonds issued in the 1980's to assist in the recovery of the savings and loan industry. The assessment amount can fluctuate, but was 0.54 basis points of insured deposits for the fourth quarter of 2017. Those assessments will continue until the Financing Corporation bonds mature in 2019.

Community Reinvestment Act

The Bank is subject to certain requirements and reporting obligations involving Community Reinvestment Act ("CRA") activities. The CRA generally requires federal banking agencies to evaluate the record of a financial institution in meeting the credit needs of its local communities, including low and moderate income neighborhoods. The

CRA further requires the agencies to consider a financial institution's efforts in meeting its community credit needs when evaluating applications for, among other things, domestic branches, mergers or acquisitions, or the formation of holding companies. In measuring a bank's compliance with its CRA obligations, the regulators utilize a performance-based evaluation system under which CRA ratings are determined by the bank's actual lending, service, and investment performance, rather than on the extent to which the institution conducts needs assessments, documents community outreach activities or complies with other procedural requirements. In connection with its assessment of CRA performance, the FDIC assigns a rating of "outstanding," "satisfactory," "needs to improve" or "substantial noncompliance." The Bank most recently received a "satisfactory" CRA assessment rating in May 2016.

Privacy and Data Security

The Gramm-Leach-Bliley Act, also known as the Financial Modernization Act of 1999 (the "Financial Modernization Act"), imposed requirements on financial institutions with respect to consumer privacy. Financial institutions, however, are required to comply with state law if it is more protective of consumer privacy than the Financial Modernization Act. The Financial Modernization Act generally prohibits disclosure of consumer information to non-affiliated third parties unless the consumer has been given the opportunity to object and has not objected to such disclosure. The statute also directed federal regulators, including the Federal Reserve and the FDIC, to establish standards for the security of consumer information, and requires financial institutions to disclose their privacy policies to consumers annually.

Overdrafts

The Electronic Funds Transfer Act, as implemented by the Federal Reserve's Regulation E, governs transfers initiated through automated teller machines ("ATMs"), point-of-sale terminals, and other electronic banking services. Regulation E prohibits financial institutions from assessing an overdraft fee for paying ATM and one-time point-of-sale debit card transactions, unless the customer affirmatively opts in to the overdraft service for those types of transactions. The opt-in provision establishes requirements for clear disclosure of fees and terms of overdraft services for ATM and one-time debit card transactions. The rule does not apply to other types of transactions, such as check, automated clearinghouse ("ACH") and recurring debit card transactions. Additionally, in November 2010 the FDIC issued its Overdraft Guidance on automated overdraft service programs, to ensure that a bank mitigates the risks associated with offering automated overdraft payment programs and complies with all consumer protection laws and regulations.

Consumer Financial Protection and Financial Privacy

Dodd-Frank created the Consumer Finance Protection Bureau (the "CFPB") as an independent entity with broad rulemaking, supervisory and enforcement authority over consumer financial products and services including deposit products, residential mortgages, home-equity loans and credit cards. The CFPB's functions include investigating consumer complaints, conducting market research, rulemaking, supervising and examining bank consumer transactions, and enforcing rules related to consumer financial products and services. CFPB regulations and guidance apply to all financial institutions, including the Bank, although only banks with $10 billion or more in assets are subject to examination by the CFPB. Banks with less than $10 billion in assets, including the Bank, are examined for compliance by their primary federal banking agency.

In January 2013, the CFPB issued final regulations governing consumer mortgage lending. Certain rules which became effective in January 2014 impose additional requirements on lenders, including the directive that lenders need to ensure the ability of their borrowers to repay mortgages. The CFPB also finalized a rule on escrow accounts for higher priced mortgage loans and a rule expanding the scope of the high-cost mortgage provision in the Truth in Lending Act. The CFPB also issued final rules implementing provisions of the Dodd-Frank Act that relate to mortgage servicing. In November 2013 the CFPB issued a final rule on integrated and simplified mortgage disclosures under the Truth in Lending Act and the Real Estate Settlement Procedures Act, which became effective in October 2015.

The CFPB has broad rulemaking authority for a wide range of consumer financial laws that apply to all banks, including, among other things, the authority to prohibit “unfair, deceptive or abusive” acts and practices. Abusive acts or practices are defined as those that materially interfere with a consumer’s ability to understand a term or con dition of a consumer financial product or service or take unreasonable advantage of a consumer's: (i) lack of financial savvy, (ii) inability to protect himself in the selection or use of consumer financial products or services, or (iii) reasonable reliance on a covered entity to act in the consumer's interests.

The Bank continues to be subject to numerous other federal and state consumer protection laws that extensively govern its relationship with its customers. Those laws include the Equal Credit Opportunity Act, the Fair Credit Reporting Act, the Truth in Lending Act, the Truth in Savings Act, the Electronic Fund Transfer Act, the Expedited Funds Availability Act, the Home Mortgage Disclosure Act, the Fair Housing Act, the Real Estate Settlement Procedures Act, the Fair Debt Collection Practices Act, the Right to Financial Privacy Act, the Service Members Civil Relief Act, and respective state-law counterparts to these laws, as well as state usury laws and laws regarding unfair and deceptive acts and practices. These and other laws require disclosures including the cost of credit and terms of deposit accounts, provide substantive consumer rights, prohibit discrimination in credit transactions, regulate the use of credit report information, provide financial privacy protections, prohibit unfair, deceptive and abusive practices, restrict the Company's ability to raise interest rates and otherwise subject the Company to substantial regulatory oversight.

In addition, as is the case with all financial institutions, the Bank is required to maintain the privacy of its customers' non-public, personal information. Such privacy requirements direct financial institutions to: (i) provide notice to customers regarding privacy policies and practices; (ii) inform customers regarding the conditions under which their non-public personal information may be disclosed to non-affiliated third parties; and (iii) give customers an option to prevent disclosure of such information to non-affiliated third parties.

Identity Theft

Under the Fair and Accurate Credit Transactions Act (the "FACT Act"), the Bank is required to develop and implement a written Identity Theft Prevention Program to detect, prevent and mitigate identity theft "red flags" in connection with certain existing accounts or the opening of certain accounts. Under the FACT Act, the Bank is required to adopt reasonable policies and procedures to (i) identify relevant red flags for covered accounts and incorporate those red flags into the program; (ii) detect red flags that have been incorporated into the program; (iii) respond appropriately to any red flags that are detected to prevent and mitigate identity theft; and (iv) ensure the program is updated periodically, to reflect changes in risks to customers or to the safety and soundness of the financial institution or creditor from identity theft. The Bank maintains a program to meet the requirements of the FACT Act and the Bank believes it is currently in compliance with these requirements.

Interstate Banking and Branching

The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (the "Interstate Act"), together with Dodd-Frank, relaxed prior interstate branching restrictions under federal law by permitting, subject to regulatory approval, state and federally chartered commercial banks to establish branches in states where the laws permit banks chartered in such states to establish branches. The Interstate Act requires regulators to consult with community organizations before permitting an interstate institution to close a branch in a low-income area. Federal banking agency regulations prohibit banks from using their interstate branches primarily for deposit production and the federal banking agencies have implemented a loan-to-deposit ratio screen to ensure compliance with this prohibition. Dodd-Frank effectively eliminated the prohibition under California law against interstate branching through de novo establishment of California branches. Interstate branches are subject to certain laws of the states in which they are located. The Bank presently does not have any interstate branches.

USA Patriot Act of 2001

The impact of the USA Patriot Act of 2001 (the "Patriot Act") on financial institutions of all kinds has been significant and wide ranging. The Patriot Act substantially enhanced anti-money laundering and financial transparency laws, and required certain regulatory authorities to adopt rules that promote cooperation among financial institutions, regulators, and law enforcement entities in identifying parties that may be involved in terrorism or money laundering. Under the Patriot Act, financial institutions are subject to prohibitions regarding specified financial transactions and account relationships, as well as enhanced due diligence and "know your customer" standards in their dealings with foreign financial institutions and foreign customers. The Patriot Act also requires all financial institutions to establish anti-money laundering programs. The Bank expanded its Bank Secrecy Act compliance staff and intensified due diligence procedures concerning the opening of new accounts to fulfill the anti-money laundering requirements of the Patriot Act, and also implemented systems and procedures to identify suspicious banking activity and report any such activity to the Financial Crimes Enforcement Network.

Incentive Compensation

In June 2010, the FRB and the FDIC issued comprehensive final guidance on incentive compensation policies intended to help ensure that banking organizations do not undermine their own safety and soundness by encouraging excessive risk-taking. The guidance, which covers all employees who have the ability to materially affect the risk profile of an organization, either individually or as part of a group, is based upon the key principles that incentive compensation arrangements should (i) provide incentives that do not encourage risk-taking beyond the organization's ability to effectively identify and manage risks, (ii) be compatible with effective internal controls and risk management, and (iii) be supported by strong corporate governance, including active and effective oversight by the organization's board of directors. The regulatory agencies will review, as part of their regular risk-focused examination process, the incentive compensation arrangements of banking organizations, such as the Company, that are not "large, complex banking organizations." Where appropriate, the regulatory agencies will take supervisory or enforcement action to address perceived deficiencies in an institution's incentive compensation arrangements or related risk-management, control, and governance processes. The Company believes that it is in full compliance with the regulatory guidance on incentive compensation policies.

Sarbanes-Oxley Act of 2002

The Company is subject to the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley") which addresses, among other issues, corporate governance, auditing and accounting, executive compensation, and enhanced and timely disclosure of corporate information. Among other things, Sarbanes-Oxley mandates chief executive and chief financial officer certifications of periodic financial reports, additional financial disclosures concerning off-balance sheet items, and accelerated share transaction reporting for executive officers, directors and 10% shareholders. In addition, Sarbanes-Oxley increased penalties for non-compliance with the Exchange Act. SEC rules promulgated pursuant to Sarbanes-Oxley impose obligations and restrictions on auditors and audit committees intended to enhance their independence from Management, and include extensive additional disclosure, corporate governance and other related rules.

Commercial Real Estate Lending Concentrations

As a part of their regulatory oversight, the federal regulators have issued guidelines on sound risk management practices with respect to a financial institution's concentrations in commercial real estate ("CRE") lending activities. These guidelines were issued in response to the agencies' concerns that rising CRE concentrations might expose institutions to unanticipated earnings and capital volatility in the event of adverse changes in the commercial real estate market. The guidelines identify certain concentration levels that, if exceeded, will expose the institution to additional supervisory analysis with regard to the institution's CRE concentration risk. The guidelines are designed to promote appropriate levels of capital and sound loan and risk management practices for institutions with a concentration of CRE loans. In general, the guidelines establish the following supervisory criteria as preliminary indications of possible CRE concentration risk: (1) the institution's total construction, land development and other land loans represent 100% or more of total risk-based capital; or (2) total CRE loans as defined in the regulatory guidelines represent 300% or more of total risk-based capital, and the institution's CRE loan portfolio has increased by 50% or more during the prior 36 month period. The Bank believes that the guidelines are applicable to it, as it has a relatively high concentration in CRE loans. The Bank and its board of directors have discussed the guidelines and believe that the Bank’s underwriting policies, management information systems, independent credit administration process, and monitoring of real estate loan concentrations are sufficient to address the guidelines.

Other Pending and Proposed Legislation

Other legislative and regulatory initiatives which could affect the Company, the Bank and the banking industry in general are pending, and additional initiatives may be proposed or introduced before the United States Congress, the

California legislature and other governmental bodies in the future. Such proposals, if enacted, may further alter the structure, regulation and competitive relationship among financial institutions, and may subject the Bank to increased regulation, disclosure and reporting requirements. In addition, the various banking regulatory agencies often adopt new rules and regulations to implement and enforce existing legislation. It cannot be predicted whether, or in what form, any such legislation or regulations may be enacted or the extent to which the business of the Company or the Bank would be affected thereby.

Item 1A. RISK FACTORS

You should carefully consider the following risk factors and all other information contained in this Annual Report before making investment decisions concerning the Company's common stock. The risks and uncertainties described below are not the only ones the Company faces. Additional risks and uncertainties not presently known to the Company, or that the Company currently believes are immaterial, may also adversely impact the Company's business. If any of the events described in the following risk factors occur, the Company's business, results of operations and financial condition could be materially adversely affected. In addition, the trading price of the Company's common stock could decline due to any of the events described in these risks.

Risks Relating to the Bank and to the Business of Banking in General

Our business has been and may in the future be adversely affected by volatile conditions in the financial markets and unfavorable economic conditions generally. National and global economies are constantly in flux, as evidenced by market volatility over the past decade. Future economic conditions cannot be predicted, and recurrent deterioration in the economies of the nation as a whole or in the Company's markets could have an adverse effect, which could be material, on our business, financial condition, results of operations and future prospects, and could cause the market price of the Company's stock to decline.

From December 2007 through June 2009, the U.S. economy was officially in recession. Business activity across a wide range of industries and regions in the U.S. was greatly reduced during and after the recession. The U.S. economy has undergone a continued and gradual expansion since 2009, but financial stress on borrowers as a result of an uncertain future economic environment could still have an adverse effect on ability of the Company's borrowers to repay their loans, which could adversely affect the Company's business, financial condition and results of operations.

California's San Joaquin Valley, where the Company is headquartered and has many of its branch locations, was particularly hard hit by the most recent adverse economic cycle. Unemployment levels have historically been elevated in the San Joaquin Valley, including Tulare County which is our geographic center, but recessionary conditions pushed unemployment rates to exceptionally high levels. The unemployment rate for Tulare County reached a high of 19.3% in March 2010. It reflects a steady downward trend since 2010 and had declined to 10.1% by December 2017, but is still well above the 4.3% aggregate unemployment rate reported for California in December 2017. In addition, as discussed below in connection with challenges to the agricultural industry, the persistence of a California drought could have a significant negative impact on unemployment rates in our market areas. Furthermore, a drop in oil prices like the decline experienced in recent years could also negatively impact unemployment rates, particularly in Kern County.

Economic conditions are currently stable in most of our local markets, and the real estate sector appears to have gained momentum. However, any adverse developments could depress business and/or consumer confidence levels, negatively impact real estate values, and otherwise lead to economic weakness which could have one or more of the following undesirable effects on our business:

- a lack of demand for loans, or other products and services offered by us;

- a decline in the value of our loans or other assets secured by real estate;
- a decrease in deposit balances due to increased pressure on the liquidity of our customers;
- an impairment of our investment securities; or

- an increase in the number of borrowers who become delinquent, file for protection under bankruptcy laws or default on their loans or other obligations to us, which in turn could result in higher levels of nonperforming assets, net charge-offs and provisions for credit losses.

Challenges in the agricultural industry could have an adverse effect on our customers and their ability to make payments to us, particularly in view of recent drought conditions in California. While the Company's nonperforming assets are currently comprised mainly of other real estate owned ("OREO") and loans secured by non-agricultural real estate, difficulties experienced by the agricultural industry have led to relatively high levels of nonperforming assets in previous economic cycles. This is due to the fact that a considerable portion of our borrowers are involved in, or are impacted to some extent by, the agricultural industry. While a great number of our borrowers are not directly involved in agriculture, they would likely be impacted by difficulties in the agricultural industry since many jobs in our market areas are ancillary to the regular production, processing, marketing and sale of agricultural commodities.

The markets for agricultural products can be adversely impacted by increased supply from overseas competition, a drop in consumer demand, and numerous other factors. The ripple effect of any resulting drop in commodity prices could lower borrower income and depress collateral values. Weather patterns are also of critical importance to row crop, tree fruit, and citrus production. A degenerative cycle of weather has the potential to adversely affect agricultural industries as well as consumer purchasing power, and could lead to higher unemployment throughout the San Joaquin Valley. The state of California has recently experienced the worst drought in recorded history, and it is difficult to predict if the drought will resume and how long it might last. Another looming issue that could have a major impact on the agricultural industry involves water availability and distribution rights. If the amount of water available to agriculture becomes increasingly scarce as a result of diversion to other uses, farmers may not be able to continue to produce agricultural products at a reasonable profit, which has the potential to force many out of business. Such conditions have affected and may continue to adversely affect our borrowers and, by extension, our business, and if general agricultural conditions decline our level of nonperforming assets could increase.

While oil prices rebounded significantly in 2016 and 2017 subsequent to the precipitous drop in 2014 and 2015, the reversal of recent trends could have an adverse impact on our customers and their ability to make payments to us, particularly in areas such as Kern County where oil production is a key economic driver. The drop in oil prices led to related declines in oil property values and property taxes, and Kern County, which is home to about three quarters of California's oil production, declared a fiscal emergency in January 2015 after projecting a potential material budget gap. Kern County had access to ample fiscal reserves and it cut expenses to help address the issue, thus the County was not ultimately forced to file bankruptcy. The Company does not have material direct exposure to oil producers, but does have some indirect exposure via loans outstanding to borrowers involved in servicing oil companies. Our energy-related credits totaled $16 million at December 31, 2017, relative to $23 million at December 31, 2016 and $43 million at December 31, 2015. If cash flows are disrupted for our remaining energy-related borrowers, or if other borrowers are indirectly impacted and/or non-oil property values decline, our level of nonperforming assets and loan charge-offs could increase. Furthermore, economic multipliers to a contracting oil industry include the prospects of a depressed residential housing market and a drop in commercial real estate values, in what was historically a strong growth region for us.

Concentrations of real estate loans have negatively impacted our performance in the past, and could subject us to further risks in the event of another real estate recession or natural disaster. Our loan portfolio is heavily concentrated in real estate loans, particularly commercial real estate. At December 31, 2017, 79% of our loan portfolio consisted of real estate loans, and a sizeable portion of the remaining loan portfolio had real estate collateral as a secondary source of repayment or as an abundance of caution. Loans on commercial buildings represented approximately 52% of all real estate loans, while construction/development and land loans were 11%, loans secured by residential properties accounted for 25%, and loans secured by farmland were 12% of real estate loans. The Company's $9.4 million balance of nonperforming assets at December 31, 2017 includes nonperforming real estate loans totaling $2.5 million, and $5.5 million in foreclosed assets comprised primarily of OREO.

The Central Valley residential real estate market experienced significant deflation in property values during 2008 and 2009, and foreclosures occurred at relatively high rates during and after the recession. While residential real estate values in our market areas have stabilized or are increasing, if they were to slide again, or if commercial real estate values were to decline materially, the Company could experience additional migration into nonperforming assets. An increase in nonperforming assets could have a material adverse effect on our financial condition and results of operations by reducing our income and increasing our expenses. Deterioration in real estate values might also further reduce the amount of loans the Company makes to businesses in the construction and real estate industry, which could negatively impact our organic growth prospects. Similarly, the occurrence of more natural disasters like those California has experienced recently, including fires, flooding, and earthquakes, could impair the value of the collateral we hold for real estate secured loans and negatively impact our results of operations.

Moreover, banking regulators give commercial real estate loans extremely close scrutiny due to risks relating to the cyclical nature of the real estate market and risks for lenders with high concentrations of such loans. The regulators have required banks with relatively high levels of CRE loans to implement enhanced underwriting standards, internal controls, risk management policies and portfolio stress testing, which has resulted in higher allowances for possible loan losses. Expectations for higher capital levels have also emerged. Any required increase in our allowance for loan losses could adversely affect our net income, and any requirement that we maintain higher capital levels could adversely impact financial performance measures such as earnings per share and return on equity.

Our concentration of commercial real estate, construction and land development, and commercial and industrial loans exposes us to increased lending risks. Commercial and agricultural real estate, construction and land development, and commercial and industrial loans and leases (including agricultural production loans but excluding mortgage warehouse loans), which comprised approximately 66% of our total loan portfolio as of December 31, 2017, expose the Company to a greater risk of loss than residential real estate and consumer loans, which were a smaller percentage of the total loan portfolio. Commercial real estate and land development loans typically involve relatively large balances to a borrower or a group of related borrowers, and an adverse development with respect to a larger commercial loan relationship would expose us to greater risk of loss than issues with respect to a smaller residential mortgage loan or consumer loan.

Repayment of our commercial loans is often dependent on the cash flows of the borrowers, which may be unpredictable, and the collateral securing these loans may fluctuate in value. At December 31, 2017, we had $182 million, or 12% of total loans, in commercial loans and leases (including agricultural production loans but excluding mortgage warehouse loans). Commercial lending involves risks that are different from those associated with real estate lending. Real estate lending is generally considered to be collateral based lending with loan amounts based on predetermined loan to collateral values and liquidation of the underlying real estate collateral being viewed as the primary source of repayment in the event of borrower default. Our commercial loans are primarily extended based on the cash flows of the borrowers, and secondarily on any underlying collateral provided by the borrowers. A borrower's cash flows may be unpredictable, and collateral securing those loans may fluctuate in value. Although commercial loans are often collateralized by equipment, inventory, accounts receivable, or other business assets, the liquidation of such collateral in the event of default is often an insufficient source of repayment for a number of reasons, including uncollectible accounts receivable and obsolete or special-purpose inventories among other things.

Nonperforming assets adversely affect our results of operations and financial condition, and can take significant time to resolve. Our nonperforming loans may return to elevated levels, which would negatively impact earnings, possibly in a material way depending on the severity. We do not record interest income on non-accrual loans, thereby adversely affecting income levels. Furthermore, when we receive collateral through foreclosures and similar proceedings we are required to record the collateral at its fair market value less estimated selling costs, which may result in charges against our allowance for loan losses if that value is less than the book value of the related loan. Additionally, our non-interest expense has risen materially in adverse economic cycles due to the costs of reappraising adversely classified assets, write-downs on foreclosed assets resulting from declining property values, operating costs related to foreclosed assets, legal and other costs associated with loan collections, and various other expenses that would not typically be incurred in a normal operating environment. A relatively high level of nonperforming assets also increases our risk profile and may impact the capital levels our regulators believe is appropriate in light of such risks. We have utilized various techniques such as loan sales, workouts and restructurings to manage our problem assets. Deterioration in the value of these problem assets, the underlying collateral, or in the borrowers' performance or financial condition, could adversely affect our business, results of operations and financial condition. In addition, the resolution of nonperforming assets requires a significant commitment of time from Management and staff, which can be detrimental to their performance of other responsibilities. There can be no assurance that we will avoid increases in nonperforming loans in the future.

We may experience loan and lease losses in excess of our allowance for such losses. We endeavor to limit the risk that borrowers might fail to repay; nevertheless, losses can and do occur. We have established an allowance for estimated loan and lease losses in our accounting records based on:

- historical experience with our loans;
- our evaluation of economic conditions;
- regular reviews of the quality, mix and size of the overall loan portfolio;
- a detailed cash flow analysis for nonperforming loans;
- regular reviews of delinquencies; and
- the quality of the collateral underlying our loans.

At any given date, we maintain an allowance for loan and lease losses that we believe is adequate to absorb specifically identified probable losses as well as any other losses inherent in our loan portfolio as of that date. While we strive to carefully monitor credit quality and to identify loans that may become nonperforming, at any given time there may be loans in our portfolio that could result in losses but have not been identified as nonperforming or potential problem loans. We cannot be sure that we will identify deteriorating loans before they become nonperforming assets, or that we will be able to limit losses on loans that have been so identified. Changes in economic, operating and other conditions which are beyond our control, including interest rate fluctuations, deteriorating collateral values, and changes in the financial condition of borrowers may lead to an increase in our estimate of probable losses, or could cause actual loan losses to exceed our current allowance. In addition, the FDIC and the DBO, as part of their supervisory functions, periodically review our allowance for loan and lease losses. Such agencies may require us to increase our provision for loan and lease losses or to recognize further losses based on their judgment, which may be different from that of our Management. Any such increase in the allowance required by regulators could also hurt our business.

Our use of appraisals in deciding whether to make a loan on or secured by real property does not ensure the value of the collateral. In considering whether to make a loan secured by real property, we generally require an appraisal of the property. However, an appraisal is only an estimate of the value of the property at the time the appraisal is made, and an error in fact or judgment could adversely affect the reliability of the appraisal. In addition, events occurring after the initial appraisal may cause the value of the real estate to decrease. As a result of any of these factors the value of the collateral backing a loan may be less than supposed, and if a default occurs we may not recover the entire outstanding balance of the loan via the liquidation of such collateral.

Our expenses could increase as a result of increases in FDIC insurance premiums or other regulatory assessments. The FDIC charges insured financial institutions a premium to maintain the DIF at a certain level. In the event that deteriorating economic conditions increase bank failures, the FDIC ensures payments of deposits up to insured limits from the DIF. In August 2016, the FDIC announced that the DIF reserve ratio had surpassed 1.15% as of June 30, 2016. As a result, beginning in the third quarter of 2016, the range of initial assessment rates for all institutions was adjusted downward, although institutions with $10 billion or more in assets were assessed a quarterly surcharge. The quarterly surcharge, which does not apply to the Bank, will continue to be assessed until such time as the reserve ratio reaches the statutory minimum of 1.35% required by the Dodd-Frank Act. Although the Bank's FDIC insurance assessments have not increased as a result of these changes, there can be no assurance that the FDIC will not increase assessment rates in the future or that the Bank will not be subject to higher assessment rates as a result of a change in its risk category, either of which could have an adverse effect on the Bank’s earnings.

The future impact of changes to the Internal Revenue Code is uncertain and may adversely affect our business. The Tax Cuts and Jobs Act was signed into law in December 2017, reforming the U.S. tax code. The ultimate impact of the Tax Act on our business, customers and shareholders is uncertain but some effects could be adverse. While the decline in the maximum federal corporate tax rate from 35 percent to 21 percent will reduce our income tax expense in 2018, the legislation initially resulted in a $2.7 million decrease in the value of our deferred tax asset, which materially reduced our net income via a charge to our income tax provision in that amount for the year ended December 31, 2017. Other provisions of the Tax Act could also negatively impact our consolidated financial statements and may adversely affect us in the future.

In addition, the Tax Act could negatively impact our customers because it lowers the existing caps on mortgage interest deductions and limits state and local tax deductions. These changes may adversely impact the property values of real estate used to secure loans and create an additional tax burden on certain individuals, particularly in high state tax jurisdictions such as California where we operate. These changes could therefore make it more difficult for some borrowers to make their loan payments and could also negatively impact the housing market, which could adversely affect our business and loan growth. Any negative financial impact to our customers resulting from tax reform could adversely impact our financial condition and earnings.

We may not be able to continue to attract and retain banking customers, and our efforts to compete may reduce our profitability. The banking business in our current and intended future market areas is highly competitive with respect to virtually all products and services, which may limit our ability to attract and retain banking customers. In California generally, and in our service areas specifically, branches of major banks dominate the commercial banking industry. Such banks have substantially greater lending limits than we have, offer certain services we cannot offer directly, and often operate with economies of scale that result in relatively low operating costs. We also compete with numerous financial and quasi-financial institutions for deposits and loans, including providers of financial services via the internet. Recent advances in technology and other changes have allowed parties to effectuate financial transactions that previously required the involvement of banks. For example, consumers can maintain funds in brokerage accounts or mutual funds that would have historically been held as bank deposits. Consumers can also complete transactions such as paying bills and transferring funds directly without the assistance of banks. The process of eliminating banks as intermediaries, known as disintermediation, could result in the loss of customer deposits and the fee income generated by those deposits. The loss of these revenue streams and access to lower cost deposits as a source of funds could have a material adverse effect on our financial condition and results of operations.

Moreover, with the large number of bank failures in the past decade some customers have become more concerned about the extent to which their deposits are insured by the FDIC. Customers may withdraw deposits in an effort to ensure that the amount they have on deposit with their bank is fully insured. Decreases in deposits may adversely affect our funding costs and net income. Ultimately, competition can and does increase our cost of funds, reduce loan yields and drive down our net interest margin, thereby reducing profitability. It can also make it more difficult for us to continue to increase the size of our loan portfolio and deposit base, and could cause us to rely more heavily on wholesale borrowings which are generally more expensive than retail deposits.

If we are not able to successfully keep pace with technological changes affecting the industry, our business could be hurt. The financial services industry is constantly undergoing technological change, with the frequent introduction of new technology-driven products and services. The effective use of technology increases efficiency and enables financial institutions to better serve clients and reduce costs. Our future success depends, in part, upon our ability to respond to the needs of our clients by using technology to provide desired products and services and create additional operating efficiencies. Some of our competitors have substantially greater resources to invest in technological improvements. We may not be able to effectively implement new technology-driven products and services or be successful in marketing these products and services to our clients. Failure to keep pace with technological change in the financial services industry could have a material adverse impact on our business and, in turn, on our financial condition and results of operations.

Unauthorized disclosure of sensitive or confidential customer information, whether through a cyber-attack, other breach of our computer systems or any other means, could severely harm our business. In the normal course of business we collect, process and retain sensitive and confidential customer information. Despite the security measures we have in place, our facilities and systems may be vulnerable to cyber-attacks, security breaches, acts of vandalism, computer viruses, misplaced or lost data, programming and/or human errors, or other similar events.

In recent periods there has been a rise in fraudulent electronic activity, security breaches, and cyber-attacks, including in the banking sector. Some financial institutions have reported breaches of their websites and systems which have involved sophisticated and targeted attacks intended to misappropriate sensitive or confidential information, destroy or corrupt data, disable or degrade service, disrupt operations or sabotage systems. These breaches can remain undetected for an extended period of time. Furthermore, our customers and employees have been, and will continue to be, targeted by parties using fraudulent e-mails and other communications that may appear to be legitimate messages sent by the Bank, in attempts to misappropriate passwords, card numbers, bank account information or other personal information or to introduce viruses or malware to personal computers. Information security risks for financial institutions have increased in part because of new technologies, mobile services and other web-based products used to conduct financial and other business transactions, as well as the increased sophistication and activities of organized crime, perpetrators of fraud, hackers, terrorists and others. The secure maintenance and transmission of confidential information, as well as the secure and reliable execution of transactions over our systems, are essential to protect us and our customers and to maintain our customers' confidence. Despite our efforts to identify, contain and mitigate these threats through detection and response mechanisms, product improvement, the use of encryption and authentication technology, and customer and employee education, such attempted fraudulent activities directed against us, our customers, and third party service providers remain a serious issue. The pervasiveness of cyber security incidents in general and the risks of cyber-crime are complex and continue to evolve.

We also face risks related to cyber-attacks and other security breaches in connection with debit card transactions, which typically involve the transmission of sensitive information regarding our customers through various third parties. Some of these parties have in the past been the target of security breaches and cyber-attacks, and because the transactions involve third parties and environments that we do not control or secure, future security breaches or cyber-attacks affecting any of these third parties could impact us through no fault of our own, and in some cases we may have exposure and suffer losses for breaches or attacks relating to them. We also rely on third party service providers to conduct certain other aspects of our business operations, and face similar risks relating to them. While we regularly conduct security assessments on those third parties, we cannot be sure that their information security protocols are sufficient to withstand a cyber-attack or security breach.

Any cyber-attack or other security breach involving the misappropriation or loss of Company assets or those of its customers, or unauthorized disclosure of confidential customer information, could severely damage our reputation, erode confidence in the security of our systems, products and services, expose us to the risk of litigation and liability, disrupt our operations, and have a material adverse effect on our business.

If our information systems were to experience a system failure, our business and reputation could suffer. We rely heavily on communications and information systems to conduct our business. The computer systems and network infrastructure we use could be vulnerable to unforeseen problems. Our operations are dependent upon our ability to minimize service disruptions by protecting our computer equipment, systems, and network infrastructure from physical damage due to fire, power loss, telecommunications failure or a similar catastrophic event. We have protective measures in place to prevent or limit the effect of the failure or interruption of our information systems, and will continue to upgrade our security technology and update procedures to help prevent such events. However, if such failures or interruptions were to occur, they could result in damage to our reputation, a loss of customers, increased regulatory scrutiny, or possible exposure to financial liability, any of which could have a material adverse effect on our financial condition and results of operations.

We are subject to a variety of operational risks, including reputational risk, legal risk, compliance risk, the risk of fraud or theft by employees or outsiders, and the risk of clerical or record-keeping errors, which may adversely affect our business and results of operations. If personal, non-public, confidential or proprietary customer information in our possession were to be mishandled or misused, we could suffer significant regulatory consequences, reputational damage and financial loss. This could occur, for example, if information was erroneously provided to parties who are not permitted to have the information, either by fault of our systems, employees, or counterparties, or where such information is intercepted or otherwise inappropriately taken by third parties.

Because the nature of the financial services business involves a high volume of transactions, certain errors may be repeated or compounded before they are discovered and successfully remediated. Our necessary dependence upon automated systems to record and process transactions and our large transaction volume may further increase the risk that technical flaws or employee tampering or manipulation of those systems could result in losses that are difficult to detect. We also may be subject to disruptions of our operating systems arising from events that are wholly or partially beyond our control (for example, computer viruses or electrical or telecommunications outages, or natural disasters, disease pandemics or other damage to property or physical assets) which may give rise to disruption of service to customers and to financial loss or liability. We are further exposed to the risk that our external vendors may be unable to fulfill their contractual obligations (or will be subject to the same risk of fraud or operational errors by their employees) and to the risk that our (or our vendors') business continuity and data security efforts might prove to be inadequate. The occurrence of any of these risks could result in a diminished ability to operate our busi ness (for example, by requiring us to expend significant resources to correct the defect), as well as potential liability to clients, reputational damage and regulatory intervention, which could adversely affect our business, financial condition and results of operations, perhaps materially.

Previously enacted and potential future regulations could have a significant impact on our business, financial condition and results of operations. Dodd-Frank, which was enacted in 2010, is having a broad impact on the financial services industry, including significant regulatory and compliance changes. Many of the requirements called for in Dodd-Frank will be implemented over time, and most will be facilitated by the enactment of regulations over the course of several years. Given the uncertainty associated with the manner in which the provisions of Dodd-Frank will be implemented, the full extent to which they will impact our operations is unclear. The changes resulting from Dodd-Frank may impact the profitability of business activities, require changes to certain business practices, impose more stringent capital, liquidity and leverage requirements or otherwise adversely affect our business. In particular, the potential impact of Dodd-Frank on our operations and activities, both currently and prospectively, include, among others:

- an increase in our cost of operations due to greater regulatory oversight, supervision and examination of banks and bank holding companies, and higher deposit insurance premiums;
- the limitation of our ability to expand consumer product and service offerings due to more stringent consumer protection laws and regulations;
- a negative impact on our cost of funds in a rising interest rate environment, since financial institutions can now pay interest on business checking accounts;
- a potential reduction in fee income, due to limits on interchange fees applicable to larger institutions which could ultimately lead to a competitive-driven reduction in the fees we receive; and
- a potential increase in competition due to the elimination of the remaining barriers to de novo interstate branching.

Further, we may be required to invest significant management attention and resources to evaluate and make any changes necessary to comply with new statutory and regulatory requirements under the Dodd-Frank Act, which could negatively impact results of operations and financial condition. We cannot predict whether there will be additional laws or reforms that would affect the U.S. financial system or financial institutions, when such changes may be adopted, how such changes may be interpreted and enforced or how such changes may affect us. However, the costs of complying with any additional laws or regulations could have a material adverse effect on our financial condition and results of operations.

Growing by acquisition entails integration and certain other risks, and our financial condition and results of operations could be negatively affected if our expansion efforts are unsuccessful or we fail to manage our growth effectively. In addition to organic growth and the establishment of de novo branches, over the past several years we have engaged in expansion through acquisitions of branches and whole institutions. We intend to continue pursuing this growth strategy within our current footprint and via geographic expansion. There are risks associated with any such expansion. Those risks include, among others, incorrectly assessing the asset quality of a bank acquired in a particular transaction, encountering greater than anticipated costs in integrating acquired businesses, facing resistance from customers or employees, and being unable to profitably deploy assets acquired in the transaction. To the extent we issue capital stock in connection with additional transactions, if any, these transactions and related stock issuances may have a dilutive effect on earnings per share and share ownership.

Our earnings, financial condition, and prospects after a merger or acquisition depend in part on our ability to successfully integrate the operations of the acquired company. We may be unable to integrate operations successfully or to achieve expected cost savings. Any cost savings which are realized may be offset by losses in revenues or other charges to earnings. There also may be business disruptions that cause us to lose customers or cause customers to remove their accounts from us and move their business to competing financial institutions. In addition, our ability to grow may be limited if we cannot make acquisitions. We compete with other financial institutions with respect to proposed acquisitions. We cannot predict if or when we will be able to identify and attract acquisition candidates or make acquisitions on favorable terms.

We may experience future goodwill impairment. In accordance with GAAP, we record assets acquired and liabilities assumed at their fair value with the excess of the purchase consideration over the net assets acquired resulting in the recognition of goodwill. As a result, acquisitions typically result in recording goodwill, as was the case with our acquisition of OCB Bancorp in October 2017 which substantially increased our goodwill. We perform a goodwill evaluation at least annually to test for goodwill impairment. As part of our testing, we first assess qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If we determine that the fair value of a reporting unit is less than its carrying amount using these qualitative factors, we then measure the impairment loss by comparing the implied fair value of goodwill with the carrying amount of that goodwill. Adverse conditions in our business climate, including a significant decline in future operating cash flows, a significant change in our stock price or market capitalization, or a deviation from our expected growth rate and performance may significantly affect the fair value of our goodwill and may trigger impairment losses, which could be materially adverse to our operating results and financial position. We cannot provide assurance that we will not be required to take an impairment charge in the future. Any impairment charge would have an adverse effect on our shareholders' equity and financial results and could cause a decline in our stock price.

Changes in accounting standards may affect our performance. Our accounting policies and methods are fundamental to how we record and report our financial condition and results of operations. From time to time the FASB and SEC change the financial accounting and reporting standards that govern the preparation of our financial statements. These changes can be difficult to predict and can materially impact how we report and record our financial condition and results of operations. In some cases, we could be required to apply a new or revised standard retroactively, resulting in a retrospective adjustment to prior financial statements.

One such change is ASU 2016-13, which was released by the FASB in 2016 and which the Company is required to adopt no later than January 1, 2020, with early adoption permitted on January 1, 2019. ASU 2016-13 includes changes to the methodology for determining the amount of the allowance for credit losses, among other things. The new credit loss model will be a significant change from the standard in place today, as it requires the Company to calculate its allowance on the basis of current expected credit losses over the lifetime of its loans (commonly referred to as the "CECL" model), instead of losses inherent in the portfolio as of a point in time. On the effective date, institutions will record a cumulative-effect balance sheet adjustment for financial assets carried at amortized cost for any change in the related allowance for loan and lease losses generated by the adoption of the new standard. The Company's preliminary evaluation indicates that when adopted, the provisions of ASU 2016-13 will impact our consolidated financial statements, particularly the level of our reserve for credit losses and shareholders' equity, which could materially affect our financial condition and future results of operations. The extent of the impact is currently unknown, and will ultimately depend upon the nature and characteristics of our loan portfolio and the macroeconomic conditions and forecasts at the adoption date.

We may be adversely affected by the financial stability of other financial institutions. Our ability to engage in routine transactions could be adversely affected by the actions and liquidity of other financial institutions. Financial institutions are often interconnected as a result of trading, clearing, counterparty, or other business relationships. We have exposure to many different industries and counterparties, and routinely execute transactions with counterparties in the financial services industry, including commercial banks, brokers and dealers, investment banks, and other institutional clients. Many of these transactions expose us to credit risk in the event of a default by a counterparty or client. Even if the transactions are collateralized, credit risk could exist if the collateral held by us cannot be liquidated at prices sufficient to recover the full amount of the credit or derivative exposure due to us. Any such losses could adversely affect our business, financial condition or results of operations.

Changes in interest rates could adversely affect our profitability, business and prospects. Net interest income, and therefore earnings, can be adversely affected by differences or changes in the interest rates on, or the repricing frequency of, our financial instruments. In addition, fluctuations in interest rates can affect the demand of customers for products and services, and an increase in the general level of interest rates may adversely affect the ability of certain borrowers to make variable-rate loan payments. Accordingly, changes in market interest rates could have a material adverse effect on the Company's asset quality, loan origination volume, financial condition, results of operations, and cash flows. This interest rate risk can arise from Federal Reserve Board monetary policies, as well as other economic, regulatory and competitive factors that are beyond our control.

We depend on our executive officers and key personnel to implement our business strategy, and could be harmed by the loss of their services. We believe that our continued growth and success depends in large part upon the skills of our management team and other key personnel. The competition for qualified personnel in the financial services industry is intense, and the loss of key personnel or an inability to attract, retain or motivate key personnel could adversely affect our business. If we are not able to retain our existing key personnel or attract additional qualified personnel, our business operations could be impaired. None of our executive officers have employment agreements.

The value of the securities in our investment portfolio may be negatively affected by market disruptions, adverse credit events or fluctuations in interest rates, which could have a material adverse impact on capital levels. Our available-for-sale investment securities are reported at their estimated fair values, and fluctuations in fair values can result from changes in market interest rates, rating agency actions, issuer defaults, illiquid markets and limited investor demand, among other things. As long as the change in the fair value of a security is not considered to be "other than temporary," we directly increase or decrease accumulated other comprehensive income in shareholders' equity by the amount of the change in fair value, net of the tax effect. Because of the size of our fixed income bond portfolio relative to total assets, a relatively large increase in market interest rates, in particular, could result in a material drop in fair values and, by extension, our capital. Investment securities that have an amortized cost in excess of their current fair value at the end of a reporting period are also evaluated for other-than-temporary impairment. If such impairment is indicated, the difference between the amortized cost and the fair value of those securities will be recorded as a charge in our income statement, which could also have a material adverse effect on our results of operations and capital levels.

We are exposed to the risk of environmental liabilities with respect to properties to which we obtain title. Approximately 79% of our loan portfolio at December 31, 2017 consisted of real estate loans. In the normal course of business we may foreclose and take title to real estate collateral, and could be subject to environmental liabilities with respect to those properties. We may be held liable to a governmental entity or to third parties for property damage, personal injury, investigation and clean-up costs incurred by these parties in connection with environmental contamination, or may be required to investigate or clean up hazardous or toxic substances, or chemical releases at a property. The costs associated with investigation or remediation activities could be substantial. In addition, if we are the owner or former owner of a contaminated site, we may be subject to common law claims by third parties based on damages and costs resulting from environmental contamination emanating from the property. These costs and claims could adversely affect our business and prospects.

Risks Related to our Common Stock

You may not be able to sell your shares at the times and in the amounts you want if the price of our stock fluctuates significantly or the trading market for our stock is not active. The trading price of our common stock could be impacted by a number of factors, many of which are outside our control. Although our stock has been listed on NASDAQ for many years and our trading volume has increased in recent periods, trading in our stock does not consistently occur in high volumes and the market for our stock cannot always be characterized as active. Thin trading in our stock may exaggerate fluctuations in the stock's value, leading to price volatility in excess of that which would occur in a more active trading market. In addition, the stock market in general is subject to fluctuations that affect the share prices and trading volumes of many companies, and these broad market fluctuations could adversely affect the market price of our common stock. Factors that could affect our common stock price in the future include but are not necessarily limited to the following:

- actual or anticipated fluctuations in our operating results and financial condition;
- changes in revenue or earnings estimates or publication of research reports and recommendations by financial analysts;
- failure to meet analysts' revenue or earnings estimates;

- speculation in the press or investment community;
- strategic actions by us or our competitors, such as acquisitions or restructurings;
- actions by shareholders;

- sales of our equity or equity-related securities, or the perception that such sales may occur;
- fluctuations in the trading volume of our common stock;
- fluctuations in the stock prices, trading volumes, and operating results of our competitors;
- market conditions in general and, in particular, for the financial services industry;
- proposed or adopted regulatory changes or developments;
- regulatory action against us;
- actual, anticipated or pending investigations, proceedings, or litigation that involve or affect us; and
- domestic and international economic factors unrelated to our performance.

The stock market and, more specifically, the market for financial institution stocks, has experienced significant volatility in the past. As a result, the market price of our common stock has at times been volatile, and could be in the future, as well. The capital and credit markets have also experienced volatility and disruption over the past several years, at times reaching unprecedented levels. In some cases, the markets have produced downward pressure on stock prices and adversely impacted credit availability for certain issuers without regard to the issuers' underlying financial strength.

We could pursue additional capital in the future, which may or may not be available on acceptable terms, could dilute the holders of our outstanding common stock, and may adversely affect the market price of our common stock. Our ability to raise additional capital, if needed, will depend on, among other things, conditions in the capital markets at the time, which are outside of our control, and our financial performance. Furthermore, any capital raising activity could dilute the holders of our outstanding common stock, and may adversely affect the market price of our common stock and performance measures such as return on equity and earnings per share.

Future acquisitions may dilute shareholder ownership and value, especially tangible book value per share. We regularly evaluate opportunities to acquire other financial institutions and/or bank branches and intend to continue to pursue such acquisitions as part of our growth strategy. Such acquisitions may involve cash, debt, and/or equity securities. Acquisitions typically involve the payment of a premium over book and market values, and, therefore, some dilution of our tangible book value per common share may occur in connection with any future acquisitions. To the extent we issue capital stock in connection with such transactions, the share ownership of our existing shareholders may be diluted.

The Company relies heavily on the payment of dividends from the Bank. Other than $4.9 million in cash available at the holding company level at December 31, 2017, the Company's ability to meet debt service requirements and to pay dividends depends on the Bank's ability to pay dividends to the Company, as the Company has no other source of significant income. However, the Bank is subject to regulations limiting the amount of dividends it may pay. For example, the payment of dividends by the Bank is affected by the requirement to maintain adequate capital pursuant to the capital adequacy guidelines issued by the Federal Deposit Insurance Corporation. If (i) any capital requirements are increased; and/or (ii) the total risk-weighted assets of the Bank increase significantly; and/or (iii) the Bank's income declines significantly, the Bank's Board of Directors may decide or be required to retain a greater portion of the Bank's earnings to achieve and maintain the required capital or asset ratios. This would reduce the amount of funds available for the payment of dividends by the Bank to the Company. Further, one or more of the Bank's regulators could prohibit the Bank from paying dividends if, in their view, such payments would constitute unsafe or unsound banking practices. The Bank's ability to pay dividends to the Company is also limited by the California Financial Code. Whether dividends are paid, and the frequency and amount of such dividends will also depend on the financial condition and performance of the Bank and the decision of the Bank's Board of Directors. Information concerning the Company's dividend policy and historical dividend practices is set forth in Item 5 below under "Dividends." However, no assurance can be given that our future performance will justify the payment of dividends in any particular year.

Your investment may be diluted because of our ability to offer stock to others, and from the exercise of stock options. The shares of our common stock do not have preemptive rights, which means that you may not be entitled to buy additional shares if shares are offered to others in the future. We are authorized to issue up to 24,000,000 shares of common stock, and as of December 31, 2017 we had 15,223,360 shares of common stock outstanding. Except for certain limitations imposed by NASDAQ, nothing restricts our ability to offer additional shares of stock for fair value to others in the future. Any issuances of common stock would dilute our shareholders' ownership interests and may dilute the per share book value of our common stock. Furthermore, when our directors and officers exercise in-the-money stock options your ownership in the Company is diluted. As of December 31, 2017, there were outstanding options to purchase an aggregate of 455,040 shares of our common stock with an average exercise price of $16.33 per share. At the same date there were an additional 850,000 shares available to grant under our 2017 Stock Incentive Plan.

Shares of our preferred stock issued in the future could have dilutive and other effects on our common stock. Our Articles of Incorporation authorize us to issue 10,000,000 shares of preferred stock, none of which is presently outstanding. Although our Board of Directors has no present intention to authorize the issuance of shares of preferred stock, such shares could be authorized in the future. If such shares of preferred stock are made convertible into shares of common stock, there could be a dilutive effect on the shares of common stock then outstanding. In addition, shares of preferred stock may be provided a preference over holders of common stock upon our liquidation or with respect to the payment of dividends, in respect of voting rights, or in the redemption of our common stock. The rights, preferences, privileges and restrictions applicable to any series or preferred stock would be determined by resolution of our Board of Directors.

The holders of our debentures have rights that are senior to those of our shareholders. In 2004 we issued $15,464,000 of junior subordinated debt securities due March 17, 2034, and in 2006 we issued an additional $15,464,000 of junior subordinated debt securities due September 23, 2036 in order to supplement regulatory capital. Moreover, the Coast Bancorp acquisition included $7,217,000 of junior subordinated debt securities due December 15, 2037. All of these junior subordinated debt securities are senior to the shares of our common stock. As a result, we must make interest payments on the debentures before any dividends can be paid on our common stock, and in the event of our bankruptcy, dissolution or liquidation, the holders of debt securities must be paid in full before any distributions may be made to the holders of our common stock. In addition, we have the right to defer interest payments on the junior subordinated debt securities for up to five years, during which time no dividends may be paid to holders of our common stock. In the event that the Bank is unable to pay dividends to us, we may be unable to pay the amounts due to the holders of the junior subordinated debt securities and thus would be unable to declare and pay any dividends on our common stock.

Provisions in our articles of incorporation could delay or prevent changes in control of our corporation or our management. Our articles of incorporation contain provisions for staggered terms of office for members of the board of directors; no cumulative voting in the election of directors; and the requirement that our board of directors consider the potential social and economic effects on our employees, depositors, customers and the communities we serve as well as certain other factors, when evaluating a possible tender offer, merger or other acquisition of the Company. These provisions make it more difficult for another company to acquire us, which could cause our shareholders to lose an opportunity to be paid a premium for their shares in an acquisition transaction and reduce the current and future market price of our common stock.

ITEM 1B. UNRESOLVED STAFF COMMENTS

Not applicable.

Item 2. Properties

The Company's administrative headquarters is housed in a 37,000 square foot, three-story office building located at 86 North Main Street, Porterville, California, and our main office consists of a one-story brick building located at 90 N. Main Street, Porterville, California, adjacent to our administrative headquarters. Both of those buildings are situated on unencumbered property owned by the Company. The Company also owns unencumbered property on which 17 of our other offices are located, namely the following branches: Porterville West Olive, Bakersfield Ming, California City, Dinuba, Exeter, Farmersville, Fresno Shaw, Hanford, Lindsay, San Luis Obispo, Santa Paula, Tehachapi Downtown, Tehachapi Old Town, Three Rivers, Tulare, Visalia Mooney and Woodlake. The remaining branches, as well as our technology center and remote ATM locations, are leased from unrelated parties. While near-term expansion is planned, Management believes that existing back-office facilities are adequate to accommodate the Company’s operations for the immediately foreseeable future.

Item 3. Legal Proceedings

From time to time the Company is a party to claims and legal proceedings arising in the ordinary course of business. After taking into consideration information furnished by counsel to the Company as to the current status of these claims or proceedings to which the Company is a party, Management is of the opinion that the ultimate aggregate liability represented thereby, if any, will not have a material adverse effect on the financial condition of the Company.

Item 4. RESERVED

PART II

Item 5. Market for REGISTRANT'S Common Equity, Related Shareholder Matters AND ISSUER PURCHASES OF EQUITY SECURITIES

(a) Market Information

Sierra Bancorp's Common Stock trades on the NASDAQ Global Select Market under the symbol BSRR, and the CUSIP number for our stock is #82620P102. Trading in the Company's Common Stock has not consistently occurred in high volumes, and such trading activity cannot always be characterized as an active trading market.

The following table summarizes trades of the Company's Common Stock, setting forth the approximate high and low sales prices and volume of trading for the periods indicated, based upon information available via public sources:

Calendar Quarter End	Sale Price Of The Company's Common Stock High	Low	Approximate Trading Volumes Shares
March 31, 2016	21.70	15.78	2,447,862
June 30, 2016	19.05	16.27	2,307,127
September 30, 2016	18.87	15.60	1,655,183
December 31, 2016	27.04	17.25	2,986,103
March 31, 2017	29.50	25.06	3,199,738
June 30, 2017	27.86	23.10	2,107,112
September 30, 2017	28.03	23.29	1,904,551
December 31, 2017	28.87	24.32	2,368,197

(b) Holders

As of January 31, 2018 there were an estimated 4,999 shareholders of the Company's Common Stock. There were 734 registered holders of record on that date, and per Broadridge, an investor communication company, there were 4,265 beneficial holders with shares held under a street name, including "objecting beneficial owners" whose names and addresses are unavailable. Since some holders maintain multiple accounts, it is likely that the above numbers overstate the actual number of the Company's shareholders to some extent.

(c) Dividends

The Company paid cash dividends totaling $7.9 million, or $0.56 per share in 2017 and $6.5 million, or $0.48 per share in 2016, which represents 41% of annual net earnings for 2017 and 37% for 2016. The Company's general dividend policy is to pay cash dividends within the range of typical peer payout ratios, provided that such payments do not adversely affect the Company's financial condition and are not overly restrictive to its growth capacity. However, in the past when many of our peers elected to suspend dividend payments, the Company's Board determined that we should continue to pay a certain level of dividends without regard to peer payout ratios, as long as our core operating performance was adequate and policy or regulatory restrictions did not preclude such payments. That said, no assurance can be given that our financial performance in any given year will justify the continued payment of a certain level of cash dividend, or any cash dividend at all.

As a bank holding company that currently has no significant assets other than its equity interest in the Bank, the Company's ability to declare dividends depends upon cash on hand as supplemented by dividends from the Bank. The

Bank’s dividend practices in turn depend upon the Bank’s earnings, financial position, regulatory standing, ability to meet current and anticipated regulatory capital requirements, and other factors deemed relevant by the Bank’s Board of Directors. The authority of the Bank’s Board of Directors to declare cash dividends is also subject to statutory restrictions. Under California banking law, the Bank may declare dividends in an amount not exceeding the lesser of its retained earnings or its net income for the last three fiscal years (reduced by distributions to the Bank’s shareholder during such period), or with the prior approval of the California Commissioner of Business Oversight in an amount not exceeding the greater of (i) the retained earnings of the Bank, (ii) the net income of the Bank for its last fiscal year, or (iii) the net income of the Bank for its current fiscal year.

The Company's ability to pay dividends is also limited by state law. California law allows a California corporation to pay dividends if the company's retained earnings equal at least the amount of the proposed dividend plus any preferred dividend arrears amount. If a California corporation does not have sufficient retained earnings available for the proposed dividend, it may still pay a dividend to its shareholders if immediately after the dividend the value of the company's assets would equal or exceed the sum of its total liabilities plus any preferred dividend arrears amount. In addition, during any period in which the Company has deferred the payment of interest otherwise due and payable on its subordinated debt securities, it may not pay any dividends or make any distributions with respect to its capital stock (see "Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations – Capital Resources").

(d) Securities Authorized for Issuance under Equity Compensation Plans

On March 16, 2017 the Company's Board of Directors approved and adopted the 2017 Stock Incentive Plan (the "2017 Plan"), which became effective May 24, 2017 pursuant to the approval of the Company's shareholders. The 2017 Plan replaced the 2007 Stock Incentive Plan (the "2007 Plan"), which expired by its own terms on March 15, 2017. The total number of shares of the Company's authorized but unissued stock reserved for issuance pursuant to awards under the 2017 Plan is 850,000 shares, and as of December 31, 2017 no awards had been granted under the 2017 Plan. The following table provides information as of December 31, 2017 with respect to options issued and still outstanding under the expired 2007 Plan, which was our only equity compensation plan with outstanding options, and options available to grant under the 2017 Plan, our only active equity compensation plan:

Plan Category	Number of Securities to be Issued Upon Exercise of Outstanding Options	Weighted-Average Exercise Price of Outstanding Options	Number of Securities Remaining Available for Future Issuance
Equity compensation plans approved by security holders	455,040	$16.33	850,000

26

(e) Performance Graph

Below is a five-year performance graph comparing the cumulative total return on the Company's common stock to the cumulative total returns of the NASDAQ Composite Index (a broad equity market index), the SNL Bank Index, and the SNL $1 billion to $5 billion Bank Index (the latter two qualifying as peer bank indices), assuming a $100 investment on December 31, 2012 and the reinvestment of dividends.

	Period Ending					
Index	12/31/12	12/31/13	12/31/14	12/31/15	12/31/16	12/31/17
Sierra Bancorp	100.00	143.27	159.64	164.63	254.96	260.10
NASDAQ Composite Index	100.00	140.12	160.78	171.97	187.22	242.71
SNL Bank $1B-$5B Index	100.00	145.41	152.04	170.20	244.85	261.04
SNL Bank Index	100.00	137.30	153.48	156.10	197.23	232.91

Source: S&P Global Market Intelligence

(f) Stock Repurchases

In September 2016 the Board authorized 500,000 shares of common stock for repurchase, subsequent to the completion of previous stock buyback plans. The authorization of shares for repurchase does not provide assurance that a specific quantity of shares will be repurchased, and the program may be suspended at any time at Management's discretion. The Company did not repurchase any shares in the fourth quarter of 2017, and there were 478,954 authorized shares remaining available for repurchase at December 31, 2017. As of the date of this report, Management has no immediate plans to resume stock repurchase activity.

Item 6. Selected Financial Data

The following table presents selected historical financial information concerning the Company, which should be read in conjunction with our audited consolidated financial statements, including the related notes, and “Management’s Discussion and Analysis of Financial Condition and Results of Operations” included elsewhere herein. The selected financial data as of December 31, 2017 and 2016, and for each of the years in the three year period ended December 31, 2017, is derived from our audited consolidated financial statements and related notes which are included in this Annual Report. The selected financial data presented for earlier years is from our audited financial statements which are not included in this Annual Report. Throughout this Annual Report, information is for the consolidated Company unless otherwise stated.

Selected Financial Data
(dollars in thousands, except per share data)

	As of and for the years ended December 31,									
Operating Data	2017		2016		2015		2014		2013	
Interest income	$80,924		$68,505		$62,707		$55,121		$51,785	
Interest expense	5,223		3,323		2,581		2,796		3,221	
Net interest income before provision for loan losses	75,701		65,182		60,126		52,325		48,564	
(Benefit) provision for loan losses	(1,140)		—		—		350		4,350	
Non-interest income	21,779		19,238		17,715		15,831		17,063	
Non-interest expense	65,441		58,053		50,703		46,375		44,815	
Income before provision for income taxes	33,179		26,367		27,138		21,431		16,462	
Provision for income taxes	13,640		8,800		9,071		6,191		3,093	
Net income	19,539		17,567		18,067		15,240		13,369	
Selected Balance Sheet Summary										
Total loans, net	1,551,551		1,255,754		1,124,602		961,056		793,087	
Allowance for loan losses	9,043		9,701		10,423		11,248		11,677	
Securities available for sale	558,329		530,083		507,582		511,883		425,044	
Cash and due from banks	70,137		120,442		48,623		50,095		78,006	
Foreclosed assets	5,481		2,225		3,193		3,991		8,185	
Premises and equipment, net	29,388		28,893		21,990		21,853		20,393	
Total interest-earning assets	2,118,875		1,827,192		1,634,180		1,474,629		1,244,795	
Total assets	2,340,298		2,032,873		1,796,537		1,637,320		1,410,249	
Total interest-bearing liabilities	1,417,590		1,277,416		1,150,010		1,038,177		845,084	
Total deposits	1,988,386		1,695,471		1,464,628		1,366,695		1,174,179	
Total liabilities	2,084,356		1,826,995		1,606,197		1,450,229		1,228,575	
Total shareholders' equity	255,942		205,878		190,340		187,091		181,674	
Per Share Data										
Net income per basic share	1.38		1.30		1.34		1.09		0.94	
Net income per diluted share	1.36		1.29		1.33		1.08		0.94	
Book value	16.81		14.94		14.36		13.67		12.78	
Cash dividends	0.56		0.48		0.42		0.34		0.26	
Weighted average common shares outstanding basic	14,172,196		13,530,293		13,460,605		14,001,958		14,155,927	
Weighted average common shares outstanding diluted	14,357,782		13,651,804		13,585,110		14,136,486		14,290,150	
Key Operating Ratios:										
Performance Ratios: [1]										
Return on average equity	8.82	%	8.71	%	9.59	%	8.18	%	7.56	%
Return on average assets	0.93	%	0.95	%	1.07	%	1.03	%	0.96	%
Net interest spread (tax-equivalent) [4]	3.90	%	3.86	%	3.92	%	3.92	%	3.90	%
Net interest margin (tax-equivalent)	4.04	%	3.95	%	3.99	%	4.01	%	4.02	%
Dividend payout ratio	40.61	%	36.97	%	31.29	%	31.33	%	27.52	%
Equity to assets ratio	10.53	%	10.93	%	11.13	%	12.58	%	12.72	%
Efficiency ratio (tax-equivalent)	65.52	%	67.23	%	63.98	%	66.30	%	66.90	%
	78.03	%	74.07	%	70.32	%	70.32	%	67.54	%

Net loans to total Deposits at Period end										
Asset Quality Ratios: [1]										
Non-performing loans to total loans [2]	0.25	%	0.50	%	0.85	%	2.13	%	4.66	%
Non-performing assets to total loans and other real estate owned [2]	0.60	%	0.68	%	1.13	%	2.53	%	5.62	%
Net (recoveries) charge-offs to average loans	-0.04	%	0.06	%	0.08	%	0.09	%	0.81	%
Allowance for loan losses to net loans at period end	-0.58	%	-0.77	%	-0.93	%	-1.17	%	-1.47	%
Allowance for Loan Losses to Non-Performing Loans	-228.19	%	-152.41	%	-108.19	%	-54.40	%	-31.21	%
Regulatory Capital Ratios: [3]										
Common equity tier 1 capital to risk-weighted assets	12.84	%	14.09	%	N/A		N/A		N/A	
Tier 1 capital to adjusted average assets (leverage ratio)	11.32	%	11.92	%	12.99	%	12.99	%	14.37	%
Tier 1 capital to risk-weighted assets	14.79	%	16.53	%	17.39	%	17.39	%	20.39	%
Total capital to risk-weighted assets	15.32	%	17.25	%	18.44	%	18.44	%	21.67	%

(1) Asset quality ratios are end of period ratios. Performance ratios are based on average daily balances during the periods indicated.

(2) Performing TDR's are not included in nonperforming loans and are therefore not included in the numerators used to calculate these ratios.

(3) For definitions and further information relating to regulatory capital requirements, see "Item 1, Business - Supervision and Regulation - Capital Adequacy Requirements herein.

(4) Represents the average rate earned on interest-earning assets less the average rate paid on interest-bearing liabilities.

29

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

This discussion presents Management's analysis of the Company's financial condition as of December 31, 2017 and 2016, and the results of operations for each of the years in the three-year period ended December 31, 2017. The discussion should be read in conjunction with the Company's consolidated financial statements and the notes related thereto presented elsewhere in this Form 10-K Annual Report (see Item 8 below).

Statements contained in this report or incorporated by reference that are not purely historical are forward looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934 as amended, including the Company's expectations, intentions, beliefs, or strategies regarding the future. All forward-looking statements concerning economic conditions, growth rates, income, expenses, or other values which are included in this document are based on information available to the Company on the date noted, and the Company assumes no obligation to update any such forward-looking statements. It is important to note that the Company's actual results could materially differ from those in such forward-looking statements. Risk factors that could cause actual results to differ materially from those in forward-looking statements include but are not limited to those outlined previously in Item 1A.

Critical Accounting Policies

The Company's financial statements are prepared in accordance with accounting principles generally accepted in the United States. The financial information and disclosures contained within those statements are significantly impacted by Management's estimates and judgments, which are based on historical experience and incorporate various assumptions that are believed to be reasonable under current circumstances. Actual results may differ from those estimates under divergent conditions.

Critical accounting policies are those that involve the most complex and subjective decisions and assessments, and have the greatest potential impact on the Company's stated results of operations. In Management's opinion, the Company's critical accounting policies deal with the following areas: the establishment of the allowance for loan and lease losses, as explained in detail in Note 2 to the consolidated financial statements and in the "Provision for Loan Losses" and "Allowance for Loan and Lease Losses" sections of this discussion and analysis; the valuation of impaired loans and foreclosed assets, as discussed in Note 2 to the consolidated financial statements; income taxes and deferred tax assets and liabilities, especially with regard to the ability of the Company to recover deferred tax assets as discussed in the "Provision for Income Taxes" and "Other Assets" sections of this discussion and analysis; and goodwill and other intangible assets, which are evaluated annually for impairment and for which we have determined that no impairment exists, as discussed in Note 2 to the consolidated financial statements and in the "Other Assets" section of this discussion and analysis. Critical accounting areas are evaluated on an ongoing basis to ensure that the Company's financial statements incorporate the most recent expectations with regard to those areas.

Summary of Performance

Our operating results and balance sheet have been materially impacted by whole-bank acquisitions in 2014, 2016 and 2017, as discussed in greater detail in the applicable sections below. The Company recognized net income of $19.539 million in 2017, relative to $17.567 million in 2016 and $18.067 million in 2015. Net income per diluted share was $1.36 in 2017, as compared to $1.29 in 2016 and $1.33 for 2015. The Company's return on average assets and return on average equity were 0.93% and 8.82%, respectively, in 2017, as compared to 0.95% and 8.71%, respectively, in 2016, and 1.07% and 9.59%, respectively, for 2015. The Company's financial performance was unfavorably impacted by a $2.710 million charge to our income tax provision in 2017 as we revalued our net deferred tax asset to reflect a lower corporate income tax rate. Furthermore, we recognized nonrecurring acquisition costs in 2017 and 2016, but our core financial results have been trending better for the past several years due in part to a higher volume of loans, a strong base of core deposits, and reductions in nonperforming assets. The following are some of the major factors that impacted the Company's results of operations for the years presented in the consolidated financial statements.

- Net interest income improved by 16% in 2017 over 2016 and 8% in 2016 over 2015, due primarily to growth in average interest-earning assets that was largely funded by low-cost non-maturity deposits. The increase in average earning assets in 2017 over 2016 was the result of our acquisitions of Coast National Bank

30

in mid-2016 and Ojai Community Bank in the fourth quarter of 2017, organic loan growth, and a higher level of investments, while growth in 2016 over 2015 came from the impact of the Coast acquisition, organic loan growth, and an increase in loan participations purchased. The positive impact of asset growth was enhanced in 2017 by net interest margin expansion of nine basis points resulting in part from short-term interest rate increases and discount accretion on acquisition loans. Net interest income has also been impacted by nonrecurring items, which added $736,000 to interest income in 2017, relative to $563,000 in 2016 and $825,000 in 2015.

- We recorded a negative loan loss provision of $1.140 million in 2017, and provisions were not required in 2016 or 2015. The provision reversal in 2017 was made possible by principal recovered on charged-off loan balances, and the zero provisions for 2016 and 2015 were facilitated by the reduction of impaired loan balances, lower loan losses, and tighter underwriting standards for new and renewed loans.
- Non-interest income increased by $2.541 million, or 13%, in 2017 over 2016, and by $1.523 million, or 9%, in 2016 compared to 2015. The improvement in 2017 is comprised primarily of growth in service charges on deposit accounts and other core fee income, but also includes nonrecurring items as discussed below. For 2016 over 2015, the increase includes nonrecurring income comprised of net proceeds from life insurance policies and core increases in fees and service charge income, partially offset by lower investment gains.
- Operating expense increased by $7.388 million, or 13%, in 2017 compared to 2016, and by $7.350 million, or 14%, in 2016 over 2015. Most of the 2017 increase came from higher operating costs associated with branches added via our acquisitions as well as de novo branch expansion. Operating expense also includes nonrecurring acquisition costs, which totaled $2.225 million for the year in 2017 as compared to $2.411 million in 2016. Other nonrecurring costs are delineated below. The increase in 2016 was impacted by non-recurring acquisition costs, which totaled only $101,000 in 2015, and also by ongoing operating costs associated with branch expansion and the Coast acquisition.
- The Company had tax provisions of $13.640 million, or 41% of pre-tax income in 2017; $8.800 million, or 33% of pre-tax income in 2016; and $9.071 million, or 33% of pre-tax income in 2015. The higher tax accrual rate for 2017 is primarily the result of the aforementioned $2.710 million deferred tax asset revaluation charge, but also reflects higher taxable income relative to available tax credits. Lower pre-tax income and higher non-taxable BOLI income benefitted our tax accrual rate for 2016 over 2015, although the impact of those factors was offset by declining tax credits.

The Company's assets totaled $2.340 billion at December 31, 2017, relative to $2.033 billion at December 31, 2016. Total liabilities were $2.084 billion at the end of 2017 compared to $1.827 billion at the end of 2016, and shareholders' equity totaled $256 million at December 31, 2017 relative to $206 million at December 31, 2016. The following is a summary of key balance sheet changes during 2017.

- Total assets increased by $307 million, or 15%. The increase resulted from higher loan and investment portfolio balances and a $23 million increase in goodwill and other intangible assets, partially offset by a reduction in cash and due from banks.
- Gross loans and leases were up $295 million, or 23%. Loan growth was favorably impacted by the Ojai acquisition, which added $218 million in loans as of the acquisition date, and strong organic growth in real estate loans, net of a drop of $25 million, or 15%, in mortgage warehouse loans.
- Cash balances declined by $50 million, or 42%. The reduction in cash balances includes a $32 million decrease in interest-earning balances held in our Federal Reserve Bank account and correspondent banks, and an $18 million drop in non-earning balances.
- Our allowance for loan and lease losses totaled $9.0 million as of December 31, 2017, a reduction of $658,000, or 7%, relative to year-end 2016. The allowance fell to 0.58% of total loans at December 31, 2017 from 0.77% of total loans at December 31, 2016, due to acquisition loans which were initially booked at their fair values and thus did not require loss reserves, and credit quality improvement in the remainder of the loan portfolio.
- Deposit balances reflect net growth of $293 million, or 17%. Deposit growth in 2017 includes balances from the Ojai Community Bank and Woodlake branch acquisitions in the fourth quarter, which added $231 million and $27 million, respectively, to deposit balances at the acquisition dates, although we have seen subsequent

runoff in some higher-rate deposits from the Ojai acquisition. Furthermore, while organic deposit growth was relatively strong in the first half of the year, if acquisition balances were excluded we would have experienced net deposit runoff during the latter half of 2017.

- Total capital increased by $50 million, or 24%, ending the year with a balance of $256 million. The increase in capital is primarily the result of 1,376,431 shares issued as part of the consideration for the Ojai acquisition, but also includes capital from stock options exercised and the addition of net income, less dividends paid. The Company's regulatory capital ratios declined as a result of the acquisition and organic loan growth but remain relatively robust, and at December 31, 2017 our consolidated Common Equity Tier One Capital Ratio was 12.84%, our Tier One Risk-Based Capital Ratio was 14.79%, our Total Risk-Based Capital Ratio was 15.32%, and our Tier One Leverage Ratio was 11.32%.

Results of Operations

As noted above, acquisitions have had a material impact on our operating results in recent periods, including the recognition of nonrecurring acquisition costs as well as higher revenues and ongoing overhead expense. Net income was $19.539 million in 2017, an increase of $1.972 million, or 11%, compared to 2016. Net income dropped by $500,000, or 3%, in 2016 relative to 2015. The Company earns income from two primary sources. The first is net interest income, which is interest income generated by earning assets less interest expense on deposits and other borrowed money. The second is non-interest income, which primarily consists of customer service charges and fees but also comes from non-customer sources such as bank-owned life insurance and investment gains. The majority of the Company's non-interest expense is comprised of operating costs that facilitate offering a full range of banking services to our customers.

Net Interest Income and Net Interest Margin

Net interest income was $75.701 million in 2017, compared to $65.182 million in 2016 and $60.126 million in 2015. This equates to increases of 16% in 2017 and 8% in 2016. The level of net interest income we recognize in any given period depends on a combination of factors including the average volume and yield for interest-earning assets, the average volume and cost of interest-bearing liabilities, and the mix of products which comprise the Company's earning assets, deposits, and other interest-bearing liabilities. Net interest income is also impacted by the reversal of interest for loans placed on non-accrual status, and the recovery of interest on loans that had been on non-accrual and were paid off, sold or returned to accrual status.

The following table shows average balances for significant balance sheet categories and the amount of interest income or interest expense associated with each category for each of the past three years. The table also displays calculated yields on each major component of the Company's investment and loan portfolios, average rates paid on each key segment of the Company's interest-bearing liabilities, and our net interest margin for the noted periods.

Distribution, Rate & Yield
(dollars in thousands, except footnotes)

	Year Ended December 31,								
	2017			2016			2015		
Assets	Average Balance[1]	Income/ Expense	Average Rate/Yield[2]	Average Balance[1]	Income/ Expense	Average Rate/Yield[2]	Average Balance[1]	Income/ Expense	Average Rate/Yield[2]
Investments:									
Federal funds sold/due from banks	$34,832	$356	1.01 %	$11,210	$84	0.74 %	$11,313	$31	0.27 %
Taxable	437,194	8,578	1.94 %	415,902	7,922	1.87 %	405,987	8,192	1.99 %
Non-taxable	133,506	3,747	4.32 %	108,568	3,009	4.26 %	99,963	2,953	4.54 %
Equity	1,128	16	1.40 %	1,214	40	3.24 %	1,760	19	1.06 %
Total investments	606,660	12,697	2.39 %	536,894	11,055	2.32 %	519,023	11,195	2.43 %
Loans and Leases: [3]									
Real estate	1,029,224	53,329	5.18 %	827,868	42,107	5.09 %	730,509	38,203	5.23 %
Agricultural	49,335	2,448	4.96 %	48,730	2,143	4.40 %	32,084	1,329	4.14 %
Commercial	120,307	6,252	5.20 %	116,135	5,915	5.09 %	108,213	5,039	4.66 %
Consumer	11,471	1,329	11.59 %	13,789	1,574	11.41 %	16,981	1,707	10.05 %
Mortgage warehouse	105,352	4,690	4.45 %	144,531	5,577	3.86 %	138,106	5,103	3.69 %
Other	3,220	179	5.56 %	2,187	134	6.13 %	2,090	131	6.27 %
Total loans and leases	1,318,909	68,227	5.17 %	1,153,240	57,450	4.98 %	1,027,983	51,512	5.01 %
Total interest earning assets [4]	1,925,569	80,924	4.31 %	1,690,134	68,505	4.15 %	1,547,006	62,707	4.16 %
Other earning assets	9,018			8,045			7,385		
Non-earning assets	170,229			146,361			138,378		
Total assets	$2,104,816			$1,844,540			$1,692,769		
Liabilities and Shareholders' Equity									
Interest Bearing Deposits:									
Demand deposits	$135,713	$417	0.31 %	$131,803	$399	0.30 %	$120,363	$355	0.29 %
NOW	380,626	427	0.11 %	327,961	361	0.11 %	293,043	344	0.12 %
Savings accounts	241,746	258	0.11 %	206,234	229	0.11 %	186,224	207	0.11 %
Money market	136,915	157	0.11 %	109,027	80	0.07 %	109,479	78	0.07 %
CDAR's	32	—	—	3,700	4	0.11 %	12,007	8	0.07 %
Certificates of deposit<$100,000	74,847	292	0.39 %	75,383	236	0.31 %	77,058	247	0.32 %
Certificates of deposit>$100,000	274,298	2,211	0.81 %	238,858	865	0.36 %	215,625	535	0.25 %
Brokered deposits	—	—	—	—	—	—	644	11	1.71 %

Total interest bearing deposits	1,244,177	3,762	0.30	%	1,092,966	2,174	0.20	%	1,014,443	1,785	0.18	%
Borrowed funds:												
Federal funds purchased	166	1	0.60	%	822	6	0.73	%	6	—	—	
Repurchase agreements	8,514	34	0.40	%	8,371	33	0.39	%	8,601	35	0.41	%
Short term borrowings	7,074	58	0.82	%	28,333	127	0.45	%	14,697	31	0.21	%
Long term borrowings	—	—	—		306	—	—		2,504	13	0.52	%
TRUPS	34,496	1,368	3.97	%	33,403	983	2.94	%	30,928	717	2.32	%
Total borrowed funds	50,250	1,461	2.91	%	71,235	1,149	1.61	%	56,736	796	1.40	%
Total interest bearing liabilities	1,294,427	5,223	0.40	%	1,164,201	3,323	0.29	%	1,071,179	2,581	0.24	%
Non-interest bearing demand deposits	557,686				462,200				417,993			
Other liabilities	31,062				16,521				15,116			
Shareholders' equity	221,641				201,618				188,481			
Total Liabilities and Shareholders' Equity	$2,104,816				$1,844,540				$1,692,769			
Interest income/interest earning assets			4.31	%			4.15	%			4.16	%
Interest expense/interest earning assets			0.27	%			0.20	%			0.17	%
Net Interest Income and Margin(5)		$75,701	4.04	%		$65,182	3.95	%		$60,126	3.99	%

(1) Average balances are obtained from the best available daily or monthly data and are net of deferred fees and related direct costs.
(2) Yields and net interest margin have been computed on a tax equivalent basis.
(3) Loans are gross of the allowance for possible loan losses. Net loan fees have been included in the calculation of interest income. Net loan fees and loan acquisition FMV amortization were $629,660, $461,003, and $276,596 for the years ended December 31, 2017, 2016, and 2015 respectively.
(4) Non-accrual loans are slotted by loan type and have been included in total loans for purposes of total interest earning assets.
(5)

Net interest margin represents net interest income as a percentage of average interest-earning assets (tax-equivalent).

The Volume and Rate Variances table below sets forth the dollar difference for the comparative periods in interest earned or paid for each major category of interest-earning assets and interest-bearing liabilities, and the amount of such change attributable to fluctuations in average balances (volume) or differences in average interest rates. Volume variances are equal to the increase or decrease in average balances multiplied by prior period rates, and rate variances are equal to the change in rates multiplied by prior period average balances. Variances attributable to both rate and volume changes, calculated by multiplying the change in rates by the change in average balances, have been allocated to the rate variance.

Volume & Rate Variances
(dollars in thousands)

	Years Ended December 31,					
	2017 over 2016			2016 over 2015		
	Increase(decrease) due to			Increase(decrease) due to		
Assets:	Volume	Rate	Net	Volume	Rate	Net
Investments:						
Federal funds sold/due from time	$176	$96	$272	$—	$53	$53
Taxable	383	273	656	223	(493)	(270)
Non-taxable	691	47	738	263	(207)	56
Equity	(3)	(21)	(24)	(6)	27	21
Total investments	1,247	395	1,642	480	(620)	(140)
Loans and Leases:						
Real estate	10,241	981	11,222	5,092	(1,188)	3,904
Agricultural	27	278	305	690	124	814
Commercial	212	125	337	366	510	876
Consumer	(265)	20	(245)	(321)	188	(133)
Mortgage warehouse	(1,512)	625	(887)	237	237	474
Other	63	(18)	45	6	(3)	3
Total loans and leases	8,766	2,011	10,777	6,070	(132)	5,938
Total interest earning assets	$10,013	$2,406	$12,419	$6,550	$(752)	$5,798
Liabilities:						
Interest Bearing Deposits:						
Demand						
NOW	$12	$6	$18	$34	$10	$44
Savings accounts	58	8	66	41	(24)	17
Money Market	39	(10)	29	22	—	22
CDAR's	20	57	77	—	2	2
Certificates of deposit < $100,000	(4)	—	(4)	(6)	2	(4)
Certificates of deposit > $100,000	(2)	58	56	(5)	(6)	(11)
Brokered deposits	128	1,218	1,346	58	272	330
Total interest bearing deposits	—	—	—	(11)	—	(11)
Borrowed funds:	251	1,337	1,588	133	256	389
Borrowed funds:						
Federal funds purchased	(5)	—	(5)	—	6	6
Repurchase agreements	1	—	1	(1)	(1)	(2)
Short term borrowings	(95)	26	(69)	29	67	96
Long term borrowings	—	—	—	(11)	(2)	(13)

TRUPS	32	353	385	57	209	266
Total borrowed funds	(67)	379	312	74	279	353
Total interest bearing liabilities	184	1,716	1,900	207	535	742
Net interest income	$9,829	$690	$10,519	$6,343	$(1,287)	$5,056

The volume variance calculated for 2017 relative to 2016 was a favorable $9.829 million, due to an increase of $235 million, or 14%, in the average balance of interest-earning assets resulting from the impact of acquisitions and organic growth in loans and investments. There was also a favorable rate variance of $690,000 for 2017 over 2016. Our weighted average yield on interest-earning assets was up by 16 basis points while the weighted average cost of interest-bearing liabilities increased by 11 basis points, and the Company also benefited from the fact that the yield increase on earning assets was applied to a much higher balance than the rate change for interest-bearing liabilities. Investment yields have been increasing due to the current rising rate environment, and in response to limited investment portfolio restructuring which took place in 2017. Loan yields have risen due to the impact of higher short-term interest rates on our variable-rate loans and discount accretion on acquisition loans. The comparative results were also impacted by non-recurring interest items, which can include things such as interest recoveries on non-accrual loans, interest reversals for loans placed on non-accrual status, accelerated fee recognition for loan prepayments, and late fees. We had net interest recoveries of $736,000 in 2017 relative to net interest recoveries of $563,000 in 2016, for an increase of $173,000. Our weighted average cost of interest-bearing liabilities increased primarily because of higher rates paid on adjustable-rate trust-preferred securities (“TRUPS”), short-term borrowings and large time deposits.

The Company’s net interest margin, which is tax-equivalent net interest income as a percentage of average interest-earning assets, was affected by the same factors discussed above relative to rate and volume variances. Our net interest margin was 4.04% in 2017, up nine basis points relative to 2016 primarily as the result of higher loan and investment yields.

For 2016 over 2015, a favorable volume variance of $6.343 million was partially offset by an unfavorable rate variance of $1.287 million. The volume variance was due to an increase of $143 million, or 9%, in average interest-earning assets resulting from growth in loans and investments, including the impact of the Coast acquisition. It was enhanced by strong growth in the average balance of loans relative to lower-yielding investments. The negative rate variance, which resulted from lower yields on investments and loans combined with a slightly higher weighted average rate on interest-bearing liabilities, was exacerbated by the volume differential between interest-earning assets and interest-bearing liabilities. Loan yields were impacted in part by nonrecurring interest income, which was down $262,000 in 2016 relative to 2015. Our net interest margin was 3.95% in 2016, or four basis points lower than in 2015.

Provision for Loan and Lease Losses

Credit risk is inherent in the business of making loans. The Company sets aside an allowance for loan and lease losses, a contra-asset account, through periodic charges to earnings which are reflected in the income statement as the provision for loan and lease losses. The Company recorded a negative loan loss provision of $1.140 million in 2017, and did not need to record provisions in 2016 or 2015. The provision reversal in 2017 was made possible by principal recovered on charged-off loan balances, and the zero provisions for 2016 and 2015 were facilitated by the reduction of impaired loan balances, lower loan losses, and tighter underwriting standards for new and renewed loans.

Even without a regular loan loss provision in recent periods we have been able to maintain our allowance for loan and lease losses at a level that, in Management’s judgment, is adequate to absorb probable loan losses related to specifically-identified impaired loans as well as probable incurred losses in the remaining loan portfolio. Specifically identifiable and quantifiable loan losses are immediately charged off against the allowance. The Company experienced net recoveries of $482,000 on charged off balances in 2017, as compared to net loan charge-offs totaling $722,000 in 2016 and $825,000 in 2015. The need for reserve replenishment via a loan loss provision has been minimized in recent periods for the following reasons: we had net principal recoveries in 2017, which went back into the allowance; with the exception of the unanticipated charge-off of a $225,000 overdraft in 2017, charge-offs have primarily been recorded against pre-established reserves which alleviated what otherwise might have been a need for reserve replenishment; all of our acquired loans were booked at their fair values, and thus did not initially require a loan loss allowance; loss rates have been declining, thus having a positive impact on general reserves for performing loans; and, new loans booked during and since the great recession have been underwritten using tighter credit standards than was the case for many legacy loans.

The Company’s policies for monitoring the adequacy of the allowance and determining loan amounts that should be charged off, and other detailed information with regard to changes in the allowance, are discussed in Note 2 to the consolidated financial statements and below under “Allowance for Loan and Lease Losses.” The process utilized to establish an appropriate allowance for loan and lease losses can result in a high degree of variability in the Company's loan loss provision, and consequently in our net earnings.

Non-interest Revenue and Operating Expense

The table below sets forth the major components of the Company's non-interest revenue and operating expense for the years indicated, along with relevant ratios:

Non-Interest Income/Expense
(dollars in thousands)

	Year Ended December 31,					
	2017	% of Total	2016	% of Total	2015	% of Total
NON-INTEREST INCOME:						
Service charges on deposit accounts	$11,230	51.55 %	$10,151	52.76 %	$9,399	53.05 %
Checkcard fees	4,955	22.75 %	4,467	23.22 %	4,234	23.90 %
Other service charges and fees	4,052	18.61 %	3,865	20.09 %	3,617	20.42 %
Bank owned life insurance income	1,640	7.53 %	994	5.17 %	907	5.12 %
Gain on sale of securities	500	2.30 %	223	1.16 %	666	3.76 %
Loss on tax credit investment	(961)	-4.41 %	(944)	-4.91 %	(1,058)	-5.97 %
Other	363	1.67 %	482	2.51 %	(50)	-0.28 %
Total non-interest income	21,779	100.00 %	19,238	100.00 %	17,715	100.00 %
As a % of average interest-earning assets		1.13 %		1.14 %		1.15 %
OTHER OPERATING EXPENSES:						
Salaries and employee benefits	31,506	48.14 %	27,452	47.30 %	24,871	49.05 %
Occupancy costs						
Furniture and equipment	2,674	4.09 %	2,372	4.09 %	2,060	4.06 %
Premises	6,916	10.57 %	5,394	9.29 %	4,839	9.54 %
Advertising and promotion costs	2,514	3.84 %	2,386	4.11 %	2,319	4.57 %
Data processing costs	4,365	6.67 %	3,607	6.21 %	3,426	6.76 %
Deposit services costs	4,426	6.76 %	3,737	6.44 %	3,182	6.28 %
Loan services costs						
Loan processing	1,029	1.57 %	635	1.09 %	891	1.76 %
Foreclosed assets	270	0.41 %	657	1.13 %	153	0.30 %
Other operating costs						
Telephone and data communications	1,654	2.53 %	1,552	2.67 %	1,857	3.66 %
Postage and mail	1,064	1.63 %	997	1.72 %	923	1.82 %
Other	1,089	1.67 %	902	1.55 %	800	1.58 %
Professional services costs						
Legal and accounting	1,532	2.34 %	1,675	2.89 %	1,337	2.64 %
Acquisition costs	2,225	3.40 %	2,411	4.15 %	101	0.20 %
Other professional services costs	2,266	3.46 %	1,996	3.44 %	1,785	3.52 %
Stationery and supply costs	1,309	2.00 %	1,425	2.45 %	1,296	2.56 %
Sundry & tellers	602	0.92 %	855	1.47 %	863	1.70 %
Total other operating expense	$65,441	100.00 %	$58,053	100.00 %	$50,703	100.00 %
As a % of average interest-earning assets		3.40 %		3.43 %		3.28 %
Net non-interest income as a % of average interest-earning assets		-2.27 %		-2.30 %		-2.13 %
Efficiency ratio [(1)]		65.52 %		67.23 %		63.98 %

(1) Tax Equivalent

The Company's results reflect increases in total non-interest income of $2.541 million, or 13%, in 2017 over 2016, and $1.523 million, or 9%, in 2016 over 2015. These are primarily core increases resulting from growth, as discussed in greater detail below, but several items of a nonrecurring nature have also had a significant impact over the past few years. In 2017, nonrecurring non-interest income includes $500,000 in gains on the sale of investments, $503,000 in life insurance proceeds, and $323,000 in gains from the dissolution of a low-income housing tax credit fund investment. Nonrecurring non-interest income for 2016 was comprised of $223,000 in gains on the sale of investments, $481,000 in net life insurance proceeds, and $276,000 in special dividends received pursuant to our equity investment in the Federal Home Loan Bank ("FHLB"), while 2015 includes $666,000 in investment gains and $245,000 in special dividends from the FHLB. Total non-interest income was 1.13% of average interest-earning assets in 2017, relative to 1.14% in 2016 and 1.15% in 2015. The ratio has been trending slightly lower due mainly to a rising balance of interest-earning assets.

The principal component of the Company's non-interest revenue, namely service charges on deposit accounts, increased by $1.079 million, or 11%, in 2017 relative to 2016, due to fees earned on a higher number of deposit accounts, as well as a higher level of commercial deposit account activity and additional fees on higher-risk accounts. Deposit service charges increased by $752,000, or 8%, in 2016 relative to 2015 for the same reasons. The Company's ratio of service charge income to average transaction account balances was 1.0% in 2017, down slightly from 1.1% in 2016 and 2015.

The line item immediately following service charges on deposits is checkcard fees, consisting of interchange fees from our customers' use of debit cards for electronic funds transactions. This category increased by $488,000, or 11%, in 2017 over 2016 and by $233,000, or 6%, in 2016 over 2015 as a result of growth in our deposit account base, including the addition of accounts pursuant to our acquisitions. Other service charges and fees, which also constitute a relatively large portion of non-interest income, increased by $187,000, or 5%, in 2017 over 2016 and by $248,000, or 7%, in 2016 over 2015. Factoring out the impact of nonrecurring special dividends from the FHLB, as noted above, and a declining level of regular FHLB dividends, the increase in this category reflects a stronger volume of fee-generating activities.

BOLI income increased by $646,000, or 65%, in 2017 over 2016. BOLI income is derived from two types of policies owned by the Company, namely "separate account" and "general account" life insurance, and the increase in 2017 is due in large part to higher income on separate account BOLI. The Company had $6.5 million invested in separate account BOLI at December 31, 2017, which produces income that helps offset expense accruals for deferred compensation accounts the Company maintains on behalf of certain directors and senior officers. Those accounts have returns pegged to participant-directed investment allocations that can include equity, bond, or real estate indices, and are thus subject to gains or losses which often contribute to significant fluctuations in income (and associated expense accruals). Gains on separate account BOLI totaled $689,000 in 2017 relative to $151,000 in 2016, for an increase of $538,000. As noted, gains and losses on separate account BOLI are related to expense accruals or reversals associated with participant gains and losses on deferred compensation balances, thus their net impact on taxable income tends to be minimal. The Company's books also reflect a net cash surrender value of $40.6 million for general account BOLI at year-end 2017. General account BOLI generates income that is used to help offset expenses associated with executive salary continuation plans, director retirement plans and other employee benefits. Interest credit rates on general account BOLI do not change frequently so the income has typically been fairly consistent. While rate reductions and an increase in the cost of insurance for certain policies created downward pressure on general account BOLI income over the past few years, the average income crediting rate improved in 2017 due to the termination of a high-cost policy in late 2016. Furthermore, the Ojai acquisition included over $2 million in BOLI, thus income on general account BOLI reflects an increase of $108,000 for 2017.

As previously noted, we realized $500,000 in gains on the sale of investments in 2017, compared to $223,000 in 2016 and $666,000 in 2015. The next line item reflects pass-through expenses associated with our investments in low-income housing tax credit funds and other limited partnerships. Those expenses, which are netted out of revenue, increased by $17,000, or 2%, in 2017 relative to 2016, but dropped by $114,000, or 11%, in 2016 compared to 2015. If not for the aforementioned gain from the dissolution of one of the limited partnerships, the increase would have been even greater in 2017 due to new investments added in 2017 and 2016.

Other non-interest income includes gains and losses on the disposition of assets other than OREO, rent on bank-owned property other than OREO, life insurance proceeds, loan servicing income (net of amortization expense on our servicing asset), and other miscellaneous income. There was a drop of $119,000 in other non-interest income in 2017 relative to 2016 resulting from the disposition of certain fixed assets at a loss in 2017. As noted above, life insurance proceeds totaled $503,000 in 2017 relative to $481,000 in 2016, for an immaterial difference. The variance in other non-interest income for 2016 over 2015 reflects an absolute increase of $532,000, due primarily to the fact that no life insurance proceeds were received in 2015.

Total operating expense, or non-interest expense, increased by $7.388 million, or 13%, in 2017 over 2016, and by $7.350 million, or 14%, in 2016 relative to 2015. The increase for 2017 is comprised in large part of ongoing oper ating costs incidental to our acquisitions and de novo branch expansion. The increase in 2016 includes nonrecurring acquisition costs, as well as core operating expenses required to support a larger number of branches. Non-interest expense includes the following items of a nonrecurring nature: for 2017, acquisition costs of $2.225 million, lending-related costs totaling about $300,000, and net OREO expense of $270,000; for 2016, acquisition costs of $2.411 million, net OREO expense of $657,000, and a nonrecurring expense reversal of $173,000 in director retirement plan accruals subsequent to the death of a former director and the payment of split-dollar life insurance proceeds to his beneficiary; and for 2015, net OREO expense of $153,000 and one-time acquisition costs totaling $101,000. Non-interest expense was 3.40% of average earning assets in 2017, relative to 3.43% for 2016 and 3.28% in 2015. The ratios were higher in 2017 and 2016 largely because of acquisition costs.

The largest component of operating expense, namely salaries and employee benefits, was up $4.054 million, or 15%, in 2017 over 2016, and $2.581 million, or 10%, in 2016 over 2015. Personnel costs increased in 2017 due to expenses for employees retained subsequent to our acquisitions, staffing costs for de novo branch offices that commenced operations in 2017, and higher costs for temporary employees and overtime related to the Ojai whole-bank and Woodlake branch acquisitions and system conversions. The increase also includes salary adjustments in the normal course of business, costs for non-acquisition related staff additions, a relatively large increase in group health insurance costs, and higher equity incentive compensation expense related to stock options. Personnel costs for 2016 were up relative to 2015 due to the impact of the acquisition and the de novo branch, as well as salary adjustments in the normal course of business, higher staffing levels as vacant positions were filled, and higher temporary salaries and overtime costs. Components of compensation expense that can experience significant variability and are typically difficult to predict include salaries associated with successful loan originations, which are accounted for in accordance with Financial Accounting Standards Board (“FASB”) guidelines on the recognition and measurement of non-refundable fees and origination costs for lending activities, and accruals associated with employee deferred compensation plans. Loan origination salaries that were deferred from current expense for recognition over the life of related loans totaled $3.854 million for 2017, $3.430 million for 2016, and $3.058 million for 2015, with the fluctuations due to variability in successful organic loan origination activity. Employee deferred compensation expense accruals totaled $217,000 in 2017, relative to $141,000 in 2016 and $37,000 in 2015. As noted above in our discussion of BOLI income, employee deferred compensation plan accruals are related to separate account BOLI income and losses, as are directors deferred compensation accruals that are included in “other professional services,” and the net income impact of all income/expense accruals related to deferred compensation is usually minimal. Salaries and benefits were 48.14% of total operating expense in 2017, relative to 47.29% in 2016 and 49.05% in 2015. The number of full-time equivalent staff employed by the Company totaled 560 at the end of 2017, 479 at the end of 2016, and 417 at the end of 2015. The increase in 2017 over 2016 is due to the addition of former Ojai Community Bank employees and Woodlake branch staff, personnel for de novo branches opened in 2017, and certain back office additions deemed necessary to ensure a continued high level of customer service.

Total rent and occupancy expense, including furniture and equipment costs, increased by $1.824 million, or 23%, in 2017 over 2016, and by $867,000, or 13%, in 2016 over 2015. The increase in 2017 was primarily the result of expenses associated with locations added during the year, including certain non-recurring start-up costs associated with outfitting new branches, but it also includes inflationary increases related to other locations. The increase in 2016 is due to occupancy costs associated with acquisitions and branch openings, rent escalations in the normal course of business, and depreciation expense on office renovations.

Advertising and promotion costs were up by $128,000, or 5%, in 2017 over 2016, and by $67,000, or 3%, in 2016 over 2015. The increases are mainly the result of marketing efforts targeting our expanded geography, and other promotional expenses associated with opening new branches. Data processing costs increased by $758,000, or 21%, in 2017 over 2016, and by $181,000, or 5%, in 2016 over 2015. The increase in 2017 is primarily from ongoing expenses related to our acquisitions and new branches, but also includes costs associated with an online lending platform that was implemented at the beginning of 2017. The increase in 2016 is largely due to ongoing costs associated with the Coast acquisition which were partially offset by efforts to manage network and other information technology costs. Deposit services costs also increased by $689,000, or 18%, in 2017 over 2016, and by $555,000, or 17%, in 2016 over 2015. As with data processing costs, much of the increase in deposit costs is the result of ongoing expenses associated with our acquisitions, including operational costs as well as amortization expense for our core deposit intangible, and expenses for other new offices. Deposit costs were further impacted by increases in debit card processing costs due to higher activity levels.

Loan services costs are comprised of loan processing costs, and net costs associated with foreclosed assets. Loan processing costs, which include expenses for property appraisals and inspections, loan collections, demand and foreclosure activities, loan servicing, loan sales, and other miscellaneous lending costs, increased by $394,000, or 62%, in 2017 relative to 2016, but reflect a drop of $256,000, or 29%, in 2016 as compared to 2015. The increase in 2017 is due primarily to $300,000 in nonrecurring lending costs as noted above, but it also includes a higher level of appraisal, inspection and credit reporting costs incidental to more robust lending activity. The reduction in 2016 includes lower appraisal and inspection costs, and declining collection costs. Foreclosed assets costs are comprised of write-downs taken subsequent to reappraisals, OREO operating expense (including property taxes), and losses on the sale of foreclosed assets, net of rental income on OREO properties and gains on the sale of foreclosed assets. Those costs reflect a drop of $387,000 in 2017 over 2016 and an increase of $504,000 in 2016 relative to 2015. The decline in 2017 came primarily in lower OREO write-downs, while the increase in 2016 is the result of additional OREO write-downs, higher OREO operating expense, and lower gains on the sale of foreclosed assets.

The “other operating costs” category includes telecommunications expense, postage, and other miscellaneous costs. Telecommunications expense increased by $102,000, or 7%, in 2017 relative to 2016, following a reduction of $305,000, or 16%, in 2016 over 2015. The increase in 2017 is reflective of branch expansion, while the reduction for 2016 includes non-recurring credits received from prior period overbillings, but was also the result of focused efforts to increase efficiencies. Postage expense increased by $67,000, or 7%, in 2017 over 2016 and by $74,000, or 8%, in 2016 over 2015, due mainly to statements and disclosures mailed to an expanding customer base. The “Other” category under other operating costs was up by $187,000, or 21%, in 2017 over 2016 and by $102,000, or 13%, in 2016 over 2015, due primarily to higher travel costs. Travel costs rose in connection with our acquisitions and conversions, de novo branches, and increased frequency of offsite meetings.

Legal and accounting costs declined $143,000, or 9%, in 2017 relative to 2016 due to lower legal expense, primarily in the collections area. This line item increased by $338,000, or 25%, in 2016 over 2015, however, due to higher audit costs and higher legal expense. Acquisition costs, or one-time expenses directly attributable to our whole-bank and branch acquisitions, totaled $2.225 million in 2017, $2.411 million in 2016, and $101,000 in 2015. Those nonrecurring expenses are comprised primarily of termination fees for core processing contracts and certain other contracts, software conversion costs, financial advisor fees, legal costs, severance and retention amounts paid to employees of the acquired institutions, and the write-off of furniture, fixtures and equipment that were not utilized by the Company.

Other professional services costs include FDIC assessments and other regulatory expenses, directors’ costs, and certain insurance costs among other things. This category increased by $270,000, or 14%, in 2017 over 2016 and $211,000, or 12%, in 2016 over 2015. The increase in 2017 includes higher director’s deferred compensation expense, an increase stemming from a nonrecurring reversal of $173,000 in director retirement plan accruals in 2016, and higher stock option expense, partially offset by lower regulatory assessments. The increase for 2016 includes higher deferred compensation expense, an increase in directors’ fees due to an expanded Board, and equity incentive compensation costs for stock options issued to directors in 2016, partially offset by the aforementioned reversal of certain director retirement plan accruals in 2016. As with deferred compensation accruals for employees, directors’ deferred compensation accruals are related to separate account BOLI income and losses, and the net income impact of all income/expense accruals related to deferred compensation is usually minimal. Directors’ deferred compensation expense accruals totaled $598,000 in 2017, $173,000 in 2016, and $57,000 in 2015.

Stationery and supply costs fell by $116,000, or 8%, in 2017 over 2016, but increased by $129,000, or 10%, in 2016 over 2015. The drop in 2017 is primarily due to costs associated with the issuance of new debit cards incorporating EMV technology in 2016; both 2017 and 2016 include recurring costs stemming from our whole-bank acquisitions and branch expansion, as well as one-time costs to outfit new branches with Bank of the Sierra supplies. Sundry and teller costs reflect a reduction of $253,000, or 30%, in 2017 relative to 2016 due to reduced debit card losses and lower operations-related losses within our branch system. These costs were about the same in 2016 as in 2015.

The Company’s tax-equivalent overhead efficiency ratio was 65.52% in 2017, relative to 67.23% in 2016 and 63.98% in 2015. The overhead efficiency ratio represents total non-interest expense divided by the sum of fully tax-equivalent net interest and non-interest income, with the provision for loan losses and investment gains/losses excluded from the equation. The ratio was higher in 2017 and 2016 due in part to non-recurring acquisition costs incurred in those periods.

Income Taxes

Our income tax provision was $13.640 million, or 41% of pre-tax income in 2017, relative to provisions of $8.800 million, or 33% of pre-tax income in 2016 and $9.071 million, or 33% of pre-tax income in 2015. The tax accrual rate for 2017 was higher primarily because of the $2.710 million deferred tax asset revaluation charge, but it also reflects higher taxable income relative to available tax credits. Our tax accrual rate would have been even higher in 2017 if not for our adoption of FASB's Accounting Standards Update 2016-09 effective January 1, 2017, and the subsequent change in accounting methodology associated with the disqualifying disposition of Company shares issued pursuant to the exercise of incentive stock options. Prior to January 1, 2017, the favorable tax impact of disqualifying dispositions was recorded directly to equity, whereas it is now reflected in the income statement as an adjustment to our income tax provision. Disqualifying dispositions had a small impact on our tax accrual rate during the fourth quarter, but they occurred at a higher rate during the first half of 2017 and thus had a larger favorable impact on our year-to-date income tax accrual.

The Company sets aside a provision for income taxes on a monthly basis. The amount of that provision is determined by first applying the Company's statutory income tax rates to estimated taxable income, which is pre-tax book income adjusted for permanent differences, and then subtracting available tax credits. Permanent differences include but are not limited to tax-exempt interest income, BOLI income, and certain book expenses that are not allowed as tax deductions. The Company's investments in state, county and municipal bonds provided $3.711million in federal tax-exempt income in 2017, $3.001 million in 2016, and $2.953 million in 2015. Moreover, in addition to life insurance proceeds of $503,000 in 2017 and $481,000 in 2016, our bank-owned life insurance generated $1.640 million in tax-exempt income in 2017, compared to $994,000 in 2016 and $907,000 in 2015.

Our tax credits consist primarily of those generated by investments in low-income housing tax credit funds, and California state employment tax credits. We had a total of $8.4 million invested in low-income housing tax credit funds as of December 31, 2017, which are included in other assets rather than in our investment portfolio. Those investments have generated substantial tax credits over the past few years, with about $711,000 in credits available for the 2017 tax year, $686,000 in tax credits utilized in 2016, and $770,000 in tax credits utilized in 2015. The credits are dependent upon the occupancy level of the housing projects and income of the tenants, and cannot be projected with certainty. Furthermore, our capacity to utilize them will continue to depend on our ability to generate sufficient pre-tax income. We plan to invest in additional tax credit funds in the future, but if the economics of such transactions do not justify continued investments then the level of low-income housing tax credits will taper off in future years until they are substantially utilized by the end of 2028. That means that even if taxable income stayed at the same level through 2028, our tax accrual rate would gradually increase.

Financial Condition

Our acquisitions had a significant impact on balance sheet growth in 2017, as discussed in the following sections. Assets totaled $2.340 billion at the end of 2017, reflecting an increase of $307 million, or 15%, for the year. Asset growth came primarily from increases of $295 million, or 23%, in gross loan balances, $28 million, or 5%, in investment securities, and close to $23 million in goodwill and other intangible assets, offset in part by a $50 million reduction in cash and cash equivalents. Deposits were up $293 million, or 17%, reflecting very balanced growth relative to loans, while non-deposit borrowings, including junior subordinated debentures, were reduced by a net $43 million, or 40%. Total capital increased by $50 million, or 24%. The major components of the Company's balance sheet are individually analyzed below, along with information on off-balance sheet activities and exposure.

Loan and Lease Portfolio

The Company's loan and lease portfolio represents the single largest portion of invested assets, substantially greater than the investment portfolio or any other asset category, and the quality and diversification of the loan and lease portfolio are important considerations when reviewing the Company's financial condition.

The Selected Financial Data table in Item 6 above reflects the amount of loans and leases outstanding at December 31st for each year from 2013 through 2017, net of deferred fees and origination costs and the allowance for loan and lease losses. The Loan and Lease Distribution table that follows sets forth by loan type the Company's gross loans and leases outstanding, and the percentage distribution in each category at the dates indicated. The balances for each loan type include nonperforming loans, if any, but do not reflect any deferred or unamortized loan origination, extension, or commitment fees, or deferred loan origination costs. Although not reflected in the loan totals below and not currently comprising a material part of our lending activities, the Company occasionally originates and sells, or participates out portions of, loans to non-affiliated investors.

Loan and Lease Distribution
(dollars in thousands)

	As of December 31,				
	2017	2016	2015	2014	2013
Real estate:					
1-4 family residential construction	$74,256	$32,417	$14,941	$5,858	$1,720
Other construction/land	58,779	40,650	37,359	19,908	25,531
1-4 family - closed-end	204,766	137,143	137,356	114,259	87,024
Equity lines	62,590	43,443	44,233	49,717	53,723
Multi-family residential	42,930	31,631	27,222	18,718	8,485
Commercial real estate - owner occupied	263,447	253,535	218,708	218,654	186,012
Commercial real estate - non-owner occupied	379,432	244,198	165,107	132,077	106,840
Farmland	140,516	134,480	133,182	145,039	108,504
Total real estate	1,226,716	917,497	778,108	704,230	577,839
Agricultural	46,796	46,229	46,237	27,746	25,180
Commercial and industrial	135,662	123,595	113,207	113,771	103,262
Mortgage warehouse lines	138,020	163,045	180,355	106,021	73,425
Consumer loans	10,626	12,165	14,949	18,885	23,536
Total loans and leases	$1,557,820	$1,262,531	$1,132,856	$970,653	$803,242
Percentage of Total Loans and Leases					
Real estate:					
1-4 family residential construction	4.77 %	2.57 %	1.32 %	0.60 %	0.21 %
Other construction/land	3.77 %	3.22 %	3.30 %	2.05 %	3.18 %
1-4 family - closed-end	13.14 %	10.86 %	12.12 %	11.77 %	10.83 %
Equity lines	4.02 %	3.44 %	3.90 %	5.12 %	6.69 %
Multi-family residential	2.76 %	2.51 %	2.40 %	1.93 %	1.06 %
Commercial real estate - owner occupied	16.91 %	20.08 %	19.31 %	22.53 %	23.16 %
Commercial real estate - non-owner occupied	24.36 %	19.34 %	14.57 %	13.61 %	13.30 %
Farmland	9.02 %	10.65 %	11.76 %	14.94 %	13.51 %
Total real estate	78.75 %	72.67 %	68.69 %	72.55 %	71.94 %
Agricultural	3.00 %	3.66 %	4.08 %	2.86 %	3.13 %
Commercial and industrial	8.71 %	9.79 %	9.99 %	11.72 %	12.86 %
Mortgage warehouse lines	8.86 %	12.91 %	15.92 %	10.92 %	9.14 %
Consumer loans	0.68 %	0.96 %	1.32 %	1.95 %	2.93 %
	100.00 %	100.00 %	100.00 %	100.00 %	100.00 %

The Company has experienced net growth in loan and lease balances every year since 2013, in spite of fluctuations caused by variability in outstanding balances on mortgage warehouse lines, reductions associated with the resolution of impaired loans, weak loan demand in some of those years, tightened underwriting standards, and intense competi

41

tion. This growth is due in part to acquisitions, including Santa Clara Valley Bank in 2014, Coast National Bank in 2016 and Ojai Community Bank in 2017, as well as whole loan purchases and participations purchased in 2015 and 2016. Organic loan growth has also been relatively robust in recent periods, particularly with regard to commercial real estate, construction and single-family loans.

For 2017, gross loans were up by $295 million, or 23%, due to the addition of $218 million in loans via the Ojai acquisition and strong organic growth in real estate loans, net of a $25 million reduction in outstanding balances on mortgage warehouse lines. Total real estate loans increased by $309 million, or 34%, due to $189 million in balances from the Ojai acquisition and net organic growth. Agricultural production loan balances were up earlier in 2017, but due to subsequent payoffs ended the year with almost no net growth. Commercial loans reflect a net increase of $12 million, or 10%, due to $28 million in loans from the Ojai acquisition partially offset by runoff in our legacy portfolio. One large commercial relationship, in particular, had an undesirable impact when the borrower sold the business in 2017 and paid off $14 million in loans. Outstanding balances on mortgage warehouse lines declined by $25 million, or 15%, as the utilization rate on those lines dropped to 34% at December 31, 2017 from 48% at December 31, 2016. Mortgage lending activity is highly correlated with changes in interest rates and refinancing activity and has historically been subject to significant fluctuations, so no assurance can be provided with regard to our ability to maintain or grow mortgage warehouse balances. Consumer loans fell by $2 million, or 13%, during 2017. We continue to actively seek quality loan participations to supplement organic growth, but despite almost $5 million in loan participations inherited from Ojai Community Bank, the Company's total loan participations purchased declined to $32 million at December 31, 2017 from $41 million at December 31, 2016 due to paydowns during the year. Loan participations are included in the balances shown in the table above.

Management remains focused on loan growth, which combined with stronger economic activity in some of our markets has led to recent record levels in our pipeline of loans in process of approval. However, we are still experiencing a relatively high level of prepayments and mortgage warehouse lending is subject to significant fluctuations, thus no assurance can be provided with regard to future net growth in aggregate loan balances.

Loan and Lease Maturities

The following table shows the maturity distribution for total loans and leases outstanding as of December 31, 2017, including non-accruing loans, grouped by remaining scheduled principal payments:

Loans and Lease Maturity
(dollars in thousands)

	As of December 31, 2017						
	Three months or less	Three months to twelve months	One to five years	Over five years	Total	Floating rate: due after one year	Fixed rate: due after one year
Real estate	$41,576	$ 88,969	$ 113,653	$982,518	$1,226,716	$ 829,768	$266,403
Agricultural	8,318	31,328	5,611	1,539	46,796	6,041	1,109
Commercial and industrial	16,148	29,292	38,203	52,019	135,662	40,752	49,470
Mortgage warehouse lines	13,157	114,781	10,082	—	138,020	—	10,082
Consumer loans	1,262	789	4,054	4,521	10,626	1,129	7,446
Total	$80,461	$ 265,159	$ 171,603	$1,040,597	$1,557,820	$ 877,690	$334,510

For a comprehensive discussion of the Company's liquidity position, balance sheet re-pricing characteristics, and sensitivity to interest rates changes, refer to the "Liquidity and Market Risk" section of this discussion and analysis.

Off-Balance Sheet Arrangements

The Company maintains commitments to extend credit in the normal course of business, as long as there are no violations of conditions established in the outstanding contractual arrangements. Unused commitments to extend credit totaled $692 million at December 31, 2017 and $464 million at December 31, 2016, although it is not likely that all of those commitments will ultimately be drawn down. Unused commitments represented approximately 44% of gross loans outstanding at December 31, 2017 and 37% at December 31, 2016, with the increase due in part to a higher level of construction loans, which fund incrementally rather than immediately at booking, and lower utilization on mortgage warehouse lines. The Company also had undrawn letters of credit issued to customers totaling $9 million at December 31, 2017 and 2016. Off-balance sheet obligations pose potential credit risk to the Company, and a $334,000 reserve for unfunded commitments is reflected as a liability in our consolidated balance sheet at December 31, 2017. The effect on the Company's revenues, expenses, cash flows and liquidity from the unused portion of the commitments to provide credit cannot be reasonably predicted because there is no guarantee that the lines of credit will ever be used. However, the "Liquidity" section in this Form 10-K outlines resources available to draw upon should we be required to fund a significant portion of unused commitments.

In addition to unused commitments to provide credit, the Company is utilizing an $86 million letter of credit issued by the Federal Home Loan Bank on the Company's behalf as security for certain deposits and to facilitate certain credit arrangements with the Company's customers. That letter of credit is backed by loans which are pledged to the FHLB by the Company. For more information regarding the Company's off-balance sheet arrangements, see Note 12 to the consolidated financial statements in Item 8 herein.

Contractual Obligations

At the end of 2017, the Company had contractual obligations for the following payments, by type and period due:

Contractual Obligations
(dollars in thousands)

	Payments Due by Period				
	Total	Less Than 1 Year	1-3 Years	3-5 Years	More Than 5 Years
Subordinated debentures	$34,588	$ -	$ -	$ -	$ 34,588
Operating leases	13,036	1,974	4,006	3,096	3,960
Other long-term obligations	5,376	1,364	1,876	46	2,090
Total	$53,000	$ 3,339	$ 5,882	$ 3,142	$ 40,638

Nonperforming Assets

Nonperforming assets ("NPAs") are comprised of loans for which the Company is no longer accruing interest, and foreclosed assets including mobile homes and OREO. If the Company grants a concession to a borrower in financial difficulty, the loan falls into the category of a troubled debt restructuring ("TDR"), which may be designated as either nonperforming or performing depending on the loan's accrual status. The following table presents comparative data for the Company's NPAs and performing TDRs as of the dates noted:

Nonperforming Assets and Performing TDRs
(dollars in thousands)

	As of December 31,				
	2017	2016	2015	2014	2013
Real estate:					
Other construction/land	$77	$558	$457	$3,547	$5,528
1-4 family - closed-end	871	963	2,298	3,042	13,168
Equity lines	922	1,926	1,770	1,049	778
Multi-family residential	—	—	630	171	—
Commercial real estate - owner occupied	236	1,572	2,325	3,417	5,516
Commercial real estate - non-owner occupied	123	67	262	7,754	8,058
Farmland	293	39	610	51	282
TOTAL REAL ESTATE	2,522	5,125	8,352	19,031	33,330
Agricultural	—	89	—	—	470
Commercial and industrial	1,301	692	710	821	