

UNITED SECURITY BANCSHARES

Form 10-Q

November 04, 2016

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SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED SEPTEMBER 30, 2016

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

Commission file number: 000-32897

UNITED SECURITY BANCSHARES

(Exact name of registrant as specified in its charter)

CALIFORNIA

(State or other jurisdiction of incorporation or organization)

91-2112732

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

2126 Inyo Street, Fresno, California

(Address of principal executive offices)

93721

(Zip Code)

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

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

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

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

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

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

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

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

Common Stock, no par value

(Title of Class)

Shares outstanding as of October 31, 2016: 16,540,185

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PART I. Financial Information

United Security Bancshares and Subsidiaries
 Consolidated Balance Sheets – (unaudited)
 September 30, 2016 and December 31, 2015

(in thousands except shares)	September 30, 2016	December 31, 2015
Assets		
Cash and non-interest bearing deposits in other banks	\$ 29,156	\$ 29,733
Cash and due from Federal Reserve Bank	82,591	96,018
Cash and cash equivalents	111,747	125,751
Interest-bearing deposits in other banks	1,534	1,528
Investment securities available for sale (at fair value)	60,388	30,893
Loans	559,599	515,318
Unearned fees and unamortized loan origination costs, net	1,052	58
Allowance for credit losses	(8,918	) (9,713
Net loans	551,733	505,663
Accrued interest receivable	3,581	2,220
Premises and equipment – net	10,225	10,800
Other real estate owned	7,065	12,873
Goodwill	4,488	4,488
Cash surrender value of life insurance	18,738	18,337
Investment in limited partnerships	792	917
Deferred tax assets - net	5,146	5,228
Other assets	6,155	6,946
Total assets	\$ 781,592	\$ 725,644
Liabilities & Shareholders' Equity		
Liabilities		
Deposits		
Noninterest bearing	\$ 283,462	\$ 262,168
Interest bearing	387,824	359,637
Total deposits	671,286	621,805
Accrued interest payable	39	29
Accounts payable and other liabilities	6,420	5,875
Junior subordinated debentures (at fair value)	8,262	8,300
Total liabilities	686,007	636,009
Shareholders' Equity		
Common stock, no par value 20,000,000 shares authorized, 16,540,185 issued and outstanding at September 30, 2016, and 16,051,406 at December 31, 2015	55,305	52,572
Retained earnings	40,390	37,265
Accumulated other comprehensive loss	(110	) (202
Total shareholders' equity	95,585	89,635
Total liabilities and shareholders' equity	\$ 781,592	\$ 725,644

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

(In thousands except shares and EPS)	Quarter Ended		Nine Months Ended	
	September 30, 2016	2015	September 30, 2016	2015
Interest Income:				
Loans, including fees	\$7,435	\$ 6,728	\$20,722	\$ 19,641
Investment securities – AFS – taxable	244	175	618	555
Interest on deposits in FRB	72	55	348	138
Interest on deposits in other banks	2	1	6	5
Total interest income	7,753	6,959	21,694	20,339
Interest Expense:				
Interest on deposits	289	268	837	780
Interest on other borrowings	60	58	176	175
Total interest expense	349	326	1,013	955
Net Interest Income	7,404	6,633	20,681	19,384
Provision (Recovery of Provision) for Credit Losses	4	(23	) (7	) 434
Net Interest Income after (Recovery of Provision) Provision for Credit Losses	7,400	6,656	20,688	18,950
Noninterest Income:				
Customer service fees	924	963	2,867	2,661
Increase in cash surrender value of bank-owned life insurance	131	130	394	389
(Loss) gain on fair value of financial liability	(423	) 148	48	346
Gain on redemption of JR subordinated debentures	—	78	—	78
Loss on sale of investment in limited partnership	—	(23	) —	(23
Other	154	153	464	463
Total noninterest income	786	1,449	3,773	3,914
Noninterest Expense:				
Salaries and employee benefits	2,533	2,341	7,592	7,044
Occupancy expense	1,097	1,047	3,212	3,021
Data processing	23	29	108	90
Professional fees	327	277	1,116	877
Regulatory assessments	131	234	632	705
Director fees	75	78	218	202
Correspondent bank service charges	20	19	59	56
Loss (gain) on California tax credit partnership	49	(1	) 122	60
Net cost on operation of OREO	39	401	216	594
Other	570	589	1,713	1,755
Total noninterest expense	4,864	5,014	14,988	14,404
Income Before Provision for Taxes	3,322	3,091	9,473	8,460
Provision for Taxes on Income	1,282	1,205	3,643	3,283
Net Income	\$2,040	\$ 1,886	\$5,830	\$ 5,177
Net Income per common share				
Basic	\$0.12	\$ 0.11	\$0.35	\$ 0.31
Diluted	\$0.12	\$ 0.11	\$0.35	\$ 0.31
Shares on which net income per common shares were based				

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Basic	16,538,603	16,537,697	16,538,019	16,537,697
Diluted	16,547,506	16,539,834	16,543,540	16,539,745

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

(In thousands)	Three Months Ended September 30, 2016	Three Months Ended September 30, 2015	Nine Months Ended September 30, 2016	Nine Months Ended September 30, 2015
Net Income	\$ 2,040	\$ 1,886	\$ 5,830	\$ 5,177
Unrealized holdings (losses) gains on securities	(190)	189	118	(58)
Unrealized gains on unrecognized post-retirement costs	13	19	37	55
Other comprehensive (loss) income, before tax	(177)	208	155	(3)
Tax benefit (expense) related to securities	76	(76)	(47)	23
Tax expense related to unrecognized post-retirement costs	(6)	(8)	(16)	(23)
Total other comprehensive (loss) income	(107)	124	92	(3)
Comprehensive income	\$ 1,933	\$ 2,010	\$ 5,922	\$ 5,174

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

(In thousands except shares)	Common stock		Retained Earnings	Accumulated	Total
	Number of Shares	Amount		Other Comprehensive Loss	
Balance December 31, 2014	15,425,086	\$49,271	\$33,730	\$ (175)	\$82,826
Other comprehensive loss				(3)	(3)
Common stock dividends	467,402	2,435	(2,435)		—
Stock-based compensation expense		20			20
Net income			5,177		5,177
Balance September 30, 2015	15,892,488	\$51,726	\$36,472	\$ (178)	\$88,020
Other comprehensive loss				(24)	(24)
Common stock dividends	158,918	840	(840)		—
Stock-based compensation expense		6			6
Net income			1,633		1,633
Balance December 31, 2015	16,051,406	\$52,572	\$37,265	\$ (202)	\$89,635
Other comprehensive income				92	92
Common stock dividends	486,316	2,705	(2,705)		—
Stock options exercised	2,463	6			6
Stock-based compensation expense		22			22
Net income			5,830		5,830
Balance September 30, 2016	16,540,185	\$55,305	\$40,390	\$ (110)	\$95,585

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United Security Bancshares and Subsidiaries

Consolidated Statements of Cash Flows (unaudited)

	Nine months ended September 30,	
(In thousands)	2016	2015
Cash Flows From Operating Activities:		
Net Income	\$5,830	\$5,177
Adjustments to reconcile net income:to cash provided by operating activities:		
(Recovery of provision) provision for credit losses	(7)	434)
Depreciation and amortization	1,091	1,101
Amortization of investment securities	335	205
Accretion of investment securities	(25)	(24)
Increase in accrued interest receivable	(1,361)	(245)
Increase (decrease) in accrued interest payable	10	(10)
Decrease in accounts payable and accrued liabilities	(487)	(165)
Increase in unearned fees and unamortized loan origination costs, net	(994)	(469)
Decrease in income taxes receivable	2,512	1,181
Stock-based compensation expense	22	20
Benefit for deferred income taxes	20	142
Gain on sale of other real estate owned	(53)	(17)
Write down on other real estate owned	—	188
Increase in cash surrender value of bank-owned life insurance	(401)	(389)
Gain on fair value option of financial liabilities	(48)	(346)
Gain on redemption of Jr subordinated debentures	—	(78)
Loss on tax credit limited partnership interest	122	60
Loss on sale of investment in limited partnership	—	23
Net increase in other assets	(541)	(49)
Net cash provided by operating activities	6,025	6,739
Cash Flows From Investing Activities:		
Net increase in interest-bearing deposits with banks	(6)	(4)
Purchase of correspondent bank stock	(101)	(147)
Purchases of available-for-sale securities	(34,987)	—
Maturities of available-for-sale securities	2,600	9,000
Principal payments of available-for-sale securities	2,700	4,639
Net increase in loans	(41,303)	(57,456)
Cash proceeds from sales of other real estate owned	2,800	1,192
Payoff of senior liens on other real estate owned	(705)	—
Distributions from (investment in) limited partnership	2	(119)
Capital expenditures of premises and equipment	(516)	(495)
Net cash used in investing activities	(69,516)	(43,390)
Cash Flows From Financing Activities:		
Net increase in demand deposits and savings accounts	38,068	58,232
Net increase (decrease) in time deposits	11,413	(6,970)
Redemption of Jr subordinated debentures	—	(1,800)
Proceeds from exercise of stock options	6	—
Net cash provided by financing activities	49,487	49,462

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Net (decrease) increase in cash and cash equivalents	(14,004)	12,811
Cash and cash equivalents at beginning of period	125,751	103,577
Cash and cash equivalents at end of period	\$111,747	\$116,388

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

1. Organization and Summary of Significant Accounting and Reporting Policies

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

These unaudited financial statements have been prepared in accordance with generally accepted accounting principles for interim financial information on a basis consistent with the accounting policies reflected in the audited financial statements of the Company included in its 2015 Annual Report on Form 10-K. These interim financial statements do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (consisting of a normal, recurring nature) considered necessary for a fair presentation have been included. Operating results for the interim periods presented are not necessarily indicative of the results that may be expected for any other interim period or for the year as a whole.

Recently Issued Accounting Standards:

In June 2016, FASB issued ASU 2016-13, Financial Instruments- Credit Losses (Topic 326). The FASB is issuing this Update to improve financial reporting by requiring timelier recording of credit losses on loans and other financial instruments held by financial institutions and other organizations. The Update requires enhanced disclosures and judgments in estimating credit losses and also amends the accounting for credit losses on available-for-sale debt securities and purchased financial assets with credit deterioration. This amendment is effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. We are currently evaluating the impacts of this ASU on the consolidated financial statements.

In March 2016, FASB issued ASU 2016-09, Compensation-Stock Compensation (Topic 718). The Board is issuing this Update as part of its Simplification Initiative. The objective of the Simplification Initiative is to identify, evaluate, and improve areas of generally accepted accounting principles (GAAP) for which cost and complexity can be reduced while maintaining or improving the usefulness of the information provided to users of financial statements. The areas for simplification in this Update were identified through outreach for the Simplification Initiative, pre-agenda research for the Private Company Council, and the August 2014 Post-Implementation Review Report on FASB No. 123(R), Share-Based Payment. This ASU is effective for annual reporting periods beginning after December 15, 2016, including interim periods within those annual reporting periods. We are currently evaluating the impacts of this ASU on the consolidated financial statements.

In February 2016, FASB issued ASU 2016-02, Leases (Topic 842). The FASB is issuing this Update to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements. To meet that objective, the FASB is amending the FASB Accounting Standards Codification® and creating Topic 842, Leases. This Update, along with IFRS 16, Leases, are the results of the FASB’s and the International Accounting Standards Board’s (IASB’s) efforts to meet that objective and improve financial reporting. This ASU will be effective for public business entities for annual periods beginning after December 15, 2018 (i.e., calendar periods beginning on January 1, 2019), and interim periods therein. We are currently evaluating the impacts of this ASU on the consolidated financial statements.

In January 2016, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2016-01 Financial Instruments-Overall: Recognition and Measurements of Financial Assets and Financial Liabilities. This ASU requires equity investments to be measured at fair value, with changes in fair value recognized in net

income. The amendment also simplifies the impairment assessment of equity investments for which fair value is not readily determinable by requiring an entity to perform a qualitative assessment to identify impairment. The ASU is effective for fiscal years beginning after December 15, 2017, and interim periods therein. We are currently evaluating the impacts of this ASU on the consolidated financial statements. We are currently evaluating the impacts of this ASU on the consolidated financial statements, however, we believe the accounting and reporting for our mutual fund investments will be impacted.

In September 2015, FASB issued ASU 2015-16, Business Combinations (Topic 805) -Simplifying the Accounting for Measurement-Period Adjustments. GAAP requires that during the amendment period, the acquirer retrospectively adjust the provisional amounts recognized at the acquisition date with a corresponding adjustment to goodwill. Those adjustments are required when new information is obtained about facts and circumstances that existed as of the acquisition date that, if known, would have affected the measurement of the amounts initially recognized or would have resulted in the recognition of additional assets or liabilities. To simplify the accounting for adjustments made to provisional amounts recognized in a business

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combination, the amendments in this Update eliminate the requirement to retrospectively account for those adjustments. These amendments in this Update are effective for fiscal years beginning after December 15, 2015. The Company does not expect any impact on the Company's consolidated financial statements resulting from the adoption of the update.

2. Investment Securities

Following is a comparison of the amortized cost and fair value of securities available-for-sale, as of September 30, 2016 and December 31, 2015:

(in 000's)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value (Carrying Amount)
September 30, 2016				
Securities available for sale:				
U.S. Government agencies	\$ 23,671	\$ 331	\$ (80)	\$ 23,922
U.S. Government sponsored entities & agencies collateralized by mortgage obligations	32,318	315	(39)	32,594
Mutual Funds	4,000	—	(128)	3,872
Total securities available for sale	\$ 59,989	\$ 646	\$ (247)	\$ 60,388
(in 000's)				
December 31, 2015				
Securities available for sale:				
U.S. Government agencies	\$ 9,778	\$ 453	\$ (108)	\$ 10,123
U.S. Government sponsored entities & agencies collateralized by mortgage obligations	16,835	175	(52)	16,958
Mutual Funds	4,000	—	(188)	3,812
Total securities available for sale	\$ 30,613	\$ 628	\$ (348)	\$ 30,893

The amortized cost and fair value of securities available for sale at September 30, 2016, by contractual maturity, are shown below. Actual maturities may differ from contractual maturities because issuers have the right to call or prepay obligations with or without call or prepayment penalties. Contractual maturities on collateralized mortgage obligations cannot be anticipated due to allowed paydowns. Mutual funds are included in the "due in one year or less" category below.

(in 000's)	September 30, 2016	Fair Value (Carrying Amount)
Due in one year or less	\$4,002	\$ 3,874
Due after one year through five years	—	—
Due after five years through ten years	886	903
Due after ten years	22,783	23,017
Collateralized mortgage obligations	32,318	32,594
	\$59,989	\$ 60,388

There were no realized gains or losses on sales of available-for-sale securities for the three and nine month periods ended September 30, 2016 and September 30, 2015. There were no other-than-temporary impairment losses for the

three and nine month periods ended September 30, 2016 and September 30, 2015.

At September 30, 2016, available-for-sale securities with an amortized cost of approximately \$20,611,478 (fair value of \$21,123,859) were pledged as collateral for FHLB borrowings and public funds balances.

The Company had no held-to-maturity or trading securities at September 30, 2016 or December 31, 2015.

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

The following summarizes temporarily impaired investment securities:

(in 000's)	Less than 12		12 Months or		Total	
	Months		More		Fair	
September 30, 2016	Fair	Unrealized	Fair	Unrealized	Fair	Unrealized
Securities available for sale:	Value	Losses	Value	Losses	Value	Losses
	(Carrying	(Carrying	(Carrying	(Carrying	(Carrying	(Carrying
	Amount)	Amount)	Amount)	Amount)	Amount)	Amount)
U.S. Government agencies	\$12,502	\$ (80)	—	—	\$12,502	\$ (80)
U.S. Government sponsored entities & agencies collateralized by mortgage obligations	9,192	(39)	—	—	9,192	(39)
Mutual Funds	—	—	3,872	(128)	3,872	(128)
Total impaired securities	\$21,694	\$ (119)	\$3,872	\$ (128)	\$25,566	\$ (247)
December 31, 2015						
Securities available for sale:						
U.S. Government agencies	\$79	\$ (108)	\$—	\$ —	\$79	\$ (108)
U.S. Government sponsored entities & agencies collateralized by mortgage obligations	9,913	(52)	—	—	9,913	(52)
Mutual Funds	—	—	3,812	(188)	3,812	(188)
Total impaired securities	\$9,992	\$ (160)	\$3,812	\$ (188)	\$13,804	\$ (348)

Temporarily impaired securities at September 30, 2016, were comprised of one mutual fund, four U.S. government agency securities, and three U.S. government sponsored entities and agencies collateralized by mortgage obligations securities.

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

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

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

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

At September 30, 2016, the decline in market value of the impaired mutual fund, the four U.S. government agency securities, and the three U.S. government sponsored entities and agencies collateralized by mortgage obligations securities is attributable to changes in interest rates, and not credit quality. Because the Company does not have the intent to sell these impaired securities, and it is not more likely than not that it will be required to sell these securities before its anticipated recovery, the Company does not consider these securities to be other-than-temporarily impaired at September 30, 2016.

3. Loans

Loans are comprised of the following:

(in 000's)	September 30, December 31,	
	2016	2015
Commercial and Business Loans	\$ 45,814	\$ 54,503
Government Program Loans	1,899	1,323
Total Commercial and Industrial	47,713	55,826
Real Estate – Mortgage:		
Commercial Real Estate	197,533	182,554
Residential Mortgages	91,852	68,811
Home Improvement and Home Equity loans	627	867
Total Real Estate Mortgage	290,012	252,232
Real Estate Construction and Development	131,177	130,596
Agricultural	53,269	52,137
Installment	37,428	24,527
Total Loans	\$ 559,599	\$ 515,318

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

Commercial and industrial loans represent 8.5% of total loans at September 30, 2016 and are generally made to support the ongoing operations of small-to-medium sized commercial businesses. Commercial and industrial loans have a high degree of industry diversification and provide working capital, financing for the purchase of manufacturing plants and equipment, or funding for growth and general expansion of businesses. A substantial portion of commercial and industrial loans are secured by accounts receivable, inventory, leases, or other collateral including

real estate. The remainder are unsecured; however, extensions of credit are predicated upon the financial capacity of the borrower. Repayment of commercial loans is generally from the cash flow of the borrower.

Real estate mortgage loans, representing 51.8% of total loans at September 30, 2016, are secured by trust deeds on primarily commercial property, but are also secured by trust deeds on single family residences. Repayment of real estate mortgage loans generally comes from the cash flow of the borrower.

Commercial real estate mortgage loans comprise the largest segment of this loan category and are available on all types of income producing and commercial properties, including: office buildings, shopping centers; apartments

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and motels; owner occupied buildings; manufacturing facilities and more. Commercial real estate mortgage loans can also be used to refinance existing debt. Although real estate associated with the business is the primary collateral for commercial real estate mortgage loans, the underlying real estate is not the source of repayment. Commercial real estate loans are made under the premise that the loan will be repaid from the borrower's business operations, rental income associated with the real property, or personal assets.

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

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

Real estate construction and development loans, representing 23.4% of total loans at September 30, 2016, consist of loans for residential and commercial construction projects, as well as land acquisition and development, or land held for future development. Loans in this category are secured by real estate including improved and unimproved land, as well as single-family residential, multi-family residential, and commercial properties in various stages of completion. All real estate loans have established equity requirements. Repayment on construction loans generally comes from long-term mortgages with other lending institutions obtained at completion of the project.

Agricultural loans represent 9.5% of total loans at September 30, 2016 and are generally secured by land, equipment, inventory and receivables. Repayment is from the cash flow of the borrower.

Installment loans represent 6.7% of total loans at September 30, 2016 and generally consist of student loans, loans to individuals for household, family and other personal expenditures such as credit cards, automobiles or other consumer items.

In the normal course of business, the Company is party to financial instruments with off-balance sheet risk to meet the financing needs of its customers. At September 30, 2016 and December 31, 2015, these financial instruments include commitments to extend credit of \$113,058,000 and \$107,084,000, respectively, and standby letters of credit of \$2,833,000 and \$3,295,000, respectively. These instruments involve elements of credit risk in excess of the amount recognized on the consolidated balance sheet. The contract amounts of these instruments reflect the extent of the involvement the Company has in off-balance sheet financial instruments.

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

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

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

extending loans to customers.

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Past Due Loans

The Company monitors delinquency and potential problem loans on an ongoing basis through weekly reports to the Loan Committee and monthly reports to the Board of Directors. The following is a summary of delinquent loans at September 30, 2016 (in 000's):

September 30, 2016	Loans 30-60 Days Past Due	Loans 61-89 Days Past Due	Loans 90 or More Days Past Due	Total Past Due Loans	Current Loans	Total Loans	Accruing Loans 90 or More Days Past Due
Commercial and Business Loans	\$ —	\$ —	\$ —	\$ —	\$45,814	\$45,814	\$ —
Government Program Loans	—	288	—	288	1,611	1,899	—
Total Commercial and Industrial	—	288	—	288	47,425	47,713	—
Commercial Real Estate Loans	—	—	—	—	197,533	197,533	—
Residential Mortgages	—	—	383	383	91,469	91,852	—
Home Improvement and Home Equity Loans	—	—	—	—	627	627	—
Total Real Estate Mortgage	—	—	383	383	289,629	290,012	—
Real Estate Construction and Development Loans	—	—	—	—	131,177	131,177	—
Agricultural Loans	—	—	—	—	53,269	53,269	—
Consumer Loans	—	965	—	965	36,219	37,184	—
Overdraft Protection Lines	—	—	—	—	55	55	—
Overdrafts	—	—	—	—	189	189	—
Total Installment	—	965	—	965	36,463	37,428	—
Total Loans	\$ —	\$1,253	\$ 383	\$ 1,636	\$557,963	\$559,599	\$ —

The following is a summary of delinquent loans at December 31, 2015 (in 000's):

December 31, 2015	Loans 30-60 Days Past Due	Loans 61-89 Days Past Due	Loans 90 or More Days Past Due	Total Past Due Loans	Current Loans	Total Loans	Accruing Loans 90 or More Days Past Due
Commercial and Business Loans	\$ —	\$ —	\$ —	\$ —	\$54,503	\$54,503	\$ —
Government Program Loans	13	—	—	13	1,310	1,323	—
Total Commercial and Industrial	13	—	—	13	55,813	55,826	—
Commercial Real Estate Loans	721	—	—	721	181,833	182,554	—
Residential Mortgages	62	392	—	454	68,357	68,811	—
Home Improvement and Home Equity Loans	—	39	—	39	828	867	—
Total Real Estate Mortgage	783	431	—	1,214	251,018	252,232	—
Real Estate Construction and Development Loans	—	706	—	706	129,890	130,596	—
Agricultural Loans	—	—	—	—	52,137	52,137	—
Consumer Loans	—	650	—	650	23,657	24,307	—
Overdraft Protection Lines	—	—	—	—	61	61	—
Overdrafts	—	—	—	—	159	159	—
Total Installment	—	650	—	650	23,877	24,527	—
Total Loans	\$ 796	\$1,787	\$ —	\$2,583	\$512,735	\$515,318	\$ —

Nonaccrual Loans

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

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

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

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

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

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

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

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

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

Nonaccrual loans totaled \$7,747,000 and \$8,193,000 at September 30, 2016 and December 31, 2015, respectively. There were no remaining undisbursed commitments to extend credit on nonaccrual loans at September 30, 2016 or December 31, 2015.

The following is a summary of nonaccrual loan balances at September 30, 2016 and December 31, 2015 (in 000's).

	September 30, 2016	December 31, 2015
Commercial and Business Loans	\$ 282	\$ —
Government Program Loans	287	328
Total Commercial and Industrial	569	328
Commercial Real Estate Loans	1,156	1,243
Residential Mortgages	383	392
Home Improvement and Home Equity Loans	—	—
Total Real Estate Mortgage	1,539	1,635

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Real Estate Construction and Development Loans	4,674	5,580
Agricultural Loans	—	—
Consumer Loans	965	650
Overdraft Protection Lines	—	—
Overdrafts	—	—
Total Installment	965	650
Total Loans	\$ 7,747	\$ 8,193

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Impaired Loans

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

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

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

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

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

For loans secured by collateral including real estate and equipment, the fair value of the collateral less selling costs will determine the carrying value of the loan. The difference between the recorded investment in the loan and the fair value, less selling costs, determines the amount of impairment. The Company uses the measurement method based on fair value of collateral when the loan is collateral dependent and foreclosure is probable. For loans that are not considered collateral dependent, a discounted cash flow methodology is used.

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

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

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

Loans other than certain homogeneous loan portfolios are reviewed on a quarterly basis for impairment. Impaired loans are written down to estimated realizable values by the establishment of specific reserves for loan utilizing the discounted cash flow method, or charge-offs for collateral-based impaired loans, or those using observable market pricing.

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The following is a summary of impaired loans at September 30, 2016 (in 000's).

September 30, 2016	Unpaid Contractual Principal Balance	Recorded Investment With No Allowance (1)	Recorded Investment With Allowance (1)	Total Recorded Investment	Related Allowance	Average Recorded Investment (2)	Interest Recognized (2)
Commercial and Business Loans	\$ 4,936	\$ 664	\$ 4,291	\$ 4,955	\$ 735	\$ 5,105	\$ 238
Government Program Loans	357	357	—	357	—	364	24
Total Commercial and Industrial	5,293	1,021	4,291	5,312	735	5,469	262
Commercial Real Estate Loans	1,485	—	1,487	1,487	472	1,450	66
Residential Mortgages	2,869	915	1,961	2,876	163	3,268	100
Home Improvement and Home Equity Loans	—	—	—	—	—	—	—
Total Real Estate Mortgage	4,354	915	3,448	4,363	635	4,718	166
Real Estate Construction and Development Loans	5,109	5,111	—	5,111	—	10,355	272
Agricultural Loans	1	2	—	2	—	9	6
Consumer Loans	965	965	—	965	—	889	35
Overdraft Protection Lines	—	—	—	—	—	—	—
Overdrafts	—	—	—	—	—	—	—
Total Installment	965	965	—	965	—	889	35
Total Impaired Loans	\$ 15,722	\$ 8,014	\$ 7,739	\$ 15,753	\$ 1,370	\$ 21,440	\$ 741

(1) The recorded investment in loans includes accrued interest receivable of \$31,000.

(2) Information is based on the nine month period ended September 30, 2016.

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The following is a summary of impaired loans at December 31, 2015 (in 000's).

December 31, 2015	Unpaid Contractual Principal Balance	Recorded Investment With No Allowance (1)	Recorded Investment With Allowance (1)	Total Recorded Investment	Related Allowance	Average Recorded Investment (2)	Interest Recognized (2)
Commercial and Business Loans	\$ 4,855	\$ 541	\$ 4,333	\$ 4,874	\$ 530	\$ 2,537	\$ 302
Government Program Loans	327	327	—	327	—	358	29
Total Commercial and Industrial	5,182	868	4,333	5,201	530	2,895	331
Commercial Real Estate Loans	1,243	—	1,243	1,243	477	1,618	74
Residential Mortgages	4,032	1,051	2,999	4,050	158	4,092	185
Home Improvement and Home Equity Loans	—	—	—	—	—	11	—
Total Real Estate Mortgage	5,275	1,051	4,242	5,293	635	5,721	259
Real Estate Construction and Development Loans	12,489	5,340	7,179	12,519	1,282	7,781	820
Agricultural Loans	16	16	—	16	—	22	9
Consumer Loans	650	—	650	650	650	1,043	21
Overdraft Protection Lines	—	—	—	—	—	—	—
Overdrafts	—	—	—	—	—	—	—
Total Installment	650	—	650	650	650	1,043	21
Total Impaired Loans	\$ 23,612	\$ 7,275	\$ 16,404	\$ 23,679	\$ 3,097	\$ 17,462	\$ 1,440

(1) The recorded investment in loans includes accrued interest receivable of \$67,000.

(2) Information is based on the twelve month period ended December 31, 2015.

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

The average recorded investment in impaired loans for the quarters ended September 30, 2016 and 2015 was \$19,397,000 and \$14,506,000, respectively. Interest income recognized on impaired loans for the quarters ended September 30, 2016 and 2015 was approximately \$34,000 and \$199,000, respectively. For impaired nonaccrual loans, interest income recognized under a cash-basis method of accounting was approximately \$126,000 and \$126,000 for the quarters ended September 30, 2016 and 2015, respectively.

The average recorded investment in impaired loans for the nine months ended September 30, 2016 and 2015 was \$21,440,000 and \$15,550,000, respectively. Interest income recognized on impaired loans for the nine months ended September 30, 2016 and 2015 was approximately \$741,000 and \$590,000, respectively. For impaired nonaccrual loans, interest income recognized under a cash-basis method of accounting was approximately \$362,000 and \$326,000 for the nine months ended September 30, 2016 and 2015, respectively.

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Troubled Debt Restructurings

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

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

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

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

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

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

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

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

The reduction (absolute or contingent) of accrued interest.

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

The following tables illustrates TDR activity for the periods indicated:

(\$ in 000's)	Three Months Ended September 30, 2016			
	Pre-Modification of Outstanding Contracts Investment	Post-Modification Outstanding Recorded Investment	Number of Contracts which Defaulted During Period	Recorded Investment on Defaulted TDRs
Troubled Debt Restructurings				
Commercial and Business Loans	—\$	—\$	—	\$ —
Government Program Loans	—	—	—	—
Commercial Real Estate Term Loans	—	—	—	—
Single Family Residential Loans	—	—	—	—
Home Improvement and Home Equity Loans	—	—	—	—
Real Estate Construction and Development Loans	—	—	—	—

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Agricultural Loans	—	—	—	—
Consumer Loans	—	—	—	—
Overdraft Protection Lines	—	—	—	—
Total Loans	—\$	—\$	—	\$ —

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(\$ in 000's)	Nine Months Ended September 30, 2016			
	Pre-Modification of Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Number of Contracts which Defaulted During Period	Recorded Investment on Defaulted TDRs
Troubled Debt Restructurings				
Commercial and Business Loans	4 \$ 1,021	\$ 749	—	\$ —
Government Program Loans	1 100	100	—	—
Commercial Real Estate Term Loans	—	—	—	—
Single Family Residential Loans	—	—	—	—
Home Improvement and Home Equity Loans	—	—	—	—
Real Estate Construction and Development Loans	—	—	—	—
Agricultural Loans	—	—	—	—
Consumer Loans	—	—	—	—
Overdraft Protection Lines	—	—	—	—
Total Loans	5 \$ 1,121	\$ 849	—	\$ —

(\$ in 000's)	Three Months Ended September 30, 2015			
	Pre-Modification of Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Number of Contracts which Defaulted During Period	Recorded Investment on Defaulted TDRs
Troubled Debt Restructurings				
Commercial and Business Loans	1 \$ 81	\$ 81	—	\$ —
Government Program Loans	—	—	—	—
Commercial Real Estate Term Loans	—	—	—	—
Single Family Residential Loans	—	—	—	—
Home Improvement and Home Equity Loans	—	—	—	—
Real Estate Construction and Development Loans	—	—	—	—
Agricultural Loans	—	—	—	—
Consumer Loans	—	—	—	—
Overdraft Protection Lines	—	—	—	—
Total Loans	1 \$ 81	\$ 81	—	\$ —

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(\$ in 000's)	Nine Months Ended September 30, 2015		Number of Contracts which Defaulted During Period	Recorded Investment on Defaulted TDRs
	Pre- Modification of Outstanding Recorded Investment	Post- Modification Outstanding Recorded Investment		
Troubled Debt Restructurings				
Commercial and Business Loans	2 \$ 339	\$ 335	—	\$ —
Government Program Loans	—	—	—	—
Commercial Real Estate Term Loans	—	—	—	—
Single Family Residential Loans	—	—	—	—
Home Improvement and Home Equity Loans	—	—	—	—
Real Estate Construction and Development Loans	—	—	—	—
Agricultural Loans	—	—	—	—
Consumer Loans	—	—	—	—
Overdraft Protection Lines	—	—	—	—
Total Loans	2 \$ 339	\$ 335	—	\$ —

The Company makes various types of concessions when structuring TDRs including rate reductions, payment extensions, and forbearance. At September 30, 2016, the Company had 28 restructured loans totaling \$11,191,000 as compared to 29 restructured loans totaling \$18,508,000 at December 31, 2015.

The following tables summarize TDR activity by loan category for the nine months ended September 30, 2016 and September 30, 2015 (in 000's).

Nine Months Ended September 30, 2016	Commercial and Industrial	Commercial Real Estate	Residential Mortgages	Home Improvement and Home Equity	Real Estate Construction Development	Agricultural	Installment & Other	Total
Beginning balance	\$ 898	\$ 1,243	\$ 3,533	\$ —	—\$ 12,168	\$ 16	\$ 650	\$ 18,508
Defaults	—	—	—	—	—	—	—	—
Additions	849	—	—	—	—	—	—	849
Principal additions (reductions)	(501)	242	(1,148)	—	(7,059)	(15)	315	(8,166)
Ending balance	\$ 1,246	\$ 1,485	\$ 2,385	\$ —	—\$ 5,109	\$ 1	\$ 965	\$ 11,191
Allowance for loan loss	\$ 38	\$ 472	\$ 163	\$ —	—\$ —	\$ —	\$ —	\$ 673

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Nine Months Ended September 30, 2015	Commercial and Industrial	Commercial Real Estate	Residential Mortgages	Home Improvement and Home Equity	Real Estate Construction Development	Agricultural	Installment & Other	Total
Beginning balance	\$ 1,306	\$ 2,713	\$ 4,225	\$ —	—\$ 6,029	\$ 32	\$ 695	\$15,000
Defaults	—	—	—	—	—	—	—	—
Additions	81	—	256	—	—	—	—	337
Principal reductions	(376)	(1,434)	(922)	—	(236)	(12)	(45)	(3,025)
Ending balance	\$ 1,011	\$ 1,279	\$ 3,559	\$ —	—\$ 5,793	\$ 20	\$ 650	\$12,312
Allowance for loan loss	\$ 36	\$ 512	\$ 160	\$ —	—\$ 79	\$ —	\$ 135	\$922

The following tables summarize TDR activity by loan category for the quarters ended September 30, 2016 and September 30, 2015.

Three months ended September 30, 2016	Commercial and Industrial	Commercial Real Estate	Residential Mortgages	Home Improvement and Home Equity	Real Estate Construction Development	Agricultural	Installment & Other	Total
Beginning balance	\$ 1,236	\$ 1,510	\$ 2,400	\$ —	\$ 12,100	\$ 6	\$ 965	\$18,217
Defaults	—	—	—	—	—	—	—	—
Additions	—	—	—	—	—	—	—	—
Principal (reductions) additions	10	(25)	(15)	—	(6,991)	(5)	—	(7,026)
Ending balance	\$ 1,246	\$ 1,485	\$ 2,385	\$ —	\$ 5,109	\$ 1	\$ 965	\$11,191
Allowance for loan loss	\$ 38	\$ 472	\$ 163	\$ 0	\$ —	\$ —	\$ —	\$673

Three months ended September 30, 2015	Commercial and Industrial	Commercial Real Estate	Residential Mortgages	Home Improvement and Home Equity	Real Estate Construction Development	Agricultural	Installment & Other	Total
Beginning balance	\$ 975	\$ 1,302	\$ 3,638	\$ —	—\$ 5,870	\$ 24	\$ 650	\$12,459
Defaults	—	—	—	—	—	—	—	—
Additions	81	—	—	—	—	—	—	81
Principal reductions	(45)	(23)	(79)	—	(77)	(4)	—	(228)
Ending balance	\$ 1,011	\$ 1,279	\$ 3,559	\$ —	—\$ 5,793	\$ 20	\$ 650	\$12,312

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Allowance for loan loss	\$ 36	\$ 512	\$ 160	\$	—\$ 79	\$ —	\$ 135	\$922
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Credit Quality Indicators

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

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

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

Facility Rating:

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

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

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

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

Borrower Rating:

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

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

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

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

Grade 3 – This grade includes loans to borrowers with solid credit quality with minimal risk. The borrower’s balance -sheet and financial ratios are generally in line with industry averages, and the borrower has historically demonstrated the ability to manage economic adversity. Real estate and asset-based loans assigned this risk rating must have

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characteristics, which place them well above the minimum underwriting requirements for those departments. Asset-based borrowers assigned this rating must exhibit extremely favorable leverage and cash flow characteristics, and consistently demonstrate a high level of unused borrowing capacity.

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

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

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

Grade 8 – This grade includes “doubtful” loans which exhibit the same characteristics as the Substandard loans with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions and values, highly questionable and improbable. The possibility of loss is extremely high, but because of certain important and reasonably specific pending factors, which may work to the advantage and strengthening of the loan, its classification as an estimated loss is deferred until its more exact status may be determined. Pending factors include a proposed merger, acquisition, or liquidation procedures, capital injection, perfecting liens on additional collateral and refinancing plans.

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

The Company did not carry any loans graded as loss at September 30, 2016 or December 31, 2015.

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The following tables summarize the credit risk ratings for commercial, construction, and other non-consumer related loans for September 30, 2016 and December 31, 2015:

September 30, 2016 (in 000's)	Commercial and Industrial	Commercial Real Estate	Real Estate Construction and Development	Agricultural	Total
Grades 1 and 2	\$ 323	\$ —	\$ —	\$ 75	\$398
Grade 3	339	5,824	—	—	6,163
Grades 4 and 5 – pass	41,317	189,929	111,406	53,194	395,846
Grade 6 – special mention	1,058	624	912	—	2,594
Grade 7 – substandard	4,676	1,156	18,859	—	24,691
Grade 8 – doubtful	—	—	—	—	—
Total	\$ 47,713	\$ 197,533	\$ 131,177	\$ 53,269	\$429,692

December 31, 2015 (in 000's)	Commercial and Industrial	Commercial Real Estate	Real Estate Construction and Development	Agricultural	Total
Grades 1 and 2	\$ 519	\$ —	\$ —	\$ 50	\$569
Grade 3	5,008	5,964	—	—	10,972
Grades 4 and 5 – pass	44,341	173,731	103,607	52,087	373,766
Grade 6 – special mention	946	1,616	—	—	2,562
Grade 7 – substandard	5,012	1,243	26,989	—	33,244
Grade 8 – doubtful	—	—	—	—	—
Total	\$ 55,826	\$ 182,554	\$ 130,596	\$ 52,137	\$421,113

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

The following tables summarize the credit risk ratings for consumer related loans and other homogeneous loans for September 30, 2016 and December 31, 2015:

(in 000's)	September 30, 2016				December 31, 2015		
	Home Residential Mortgages and Home Equity	Improvement	Installment	Total	Home Residential Mortgages and Home Equity	Improvement	Total
Not graded	\$72,228	\$ 600					