

FEDERAL DEPOSIT INSURANCE CORPORATION

WASHINGTON, D.C. 20429

**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, 2015

FDIC Certificate No. 32203

**Summit State Bank**

(exact name of registrant as specified in its charter)

94-2878925

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

California

(State or other jurisdiction of incorporation or organization)

500 Bicentennial Way, Santa Rosa, CA 95403 Telephone: 707-568-6000

(Address of principal executive offices) (Zip Code) (Registrant's telephone number, including area code)

N/A

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports 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 is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See definition of "accelerated filer, large accelerated filer and smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller Reporting Company

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

As of November 12, 2015 there were 4,783,170 shares of common stock outstanding.

## Summit State Bank

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**Part I Financial Information**  
**Item 1 Financial Statements**

**SUMMIT STATE BANK AND SUBSIDIARY**  
**CONSOLIDATED BALANCE SHEETS**

(In thousands except share and per share data)

	<u>September 30, 2015</u>	<u>December 31, 2014</u>
	(unaudited)	
<b>ASSETS</b>		
Cash and due from banks	\$ 24,286	\$ 21,313
Federal funds sold	2,000	2,000
Total cash and cash equivalents	<u>26,286</u>	<u>23,313</u>
Time deposits with banks	744	1,240
Investment securities:		
Held-to-maturity, at amortized cost	5,987	9,977
Available-for-sale (at fair value; amortized cost of \$124,161 in 2015 and \$123,503 in 2014)	<u>125,681</u>	<u>124,723</u>
Total investment securities	131,668	134,700
Loans, less allowance for loan losses of \$4,664 in 2015 and \$5,143 in 2014	330,325	279,798
Bank premises and equipment, net	5,591	5,803
Investment in Federal Home Loan Bank stock, at cost	2,701	2,701
Goodwill	4,119	4,119
Other Real Estate Owned	-	4,051
Accrued interest receivable and other assets	<u>4,130</u>	<u>3,950</u>
Total assets	<u>\$ 505,564</u>	<u>\$ 459,675</u>
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Deposits:		
Demand - non interest-bearing	\$ 93,988	\$ 73,707
Demand - interest-bearing	46,966	55,377
Savings	28,217	25,587
Money market	65,127	58,819
Time deposits that meet or exceed the FDIC insurance limit	53,988	53,563
Other time deposits	<u>105,320</u>	<u>88,206</u>
Total deposits	393,606	355,259
Federal Home Loan Bank (FHLB) advances	52,000	35,000
Accrued interest payable and other liabilities	<u>2,969</u>	<u>1,836</u>
Total liabilities	<u>448,575</u>	<u>392,095</u>
Shareholders' equity		
Preferred stock, no par value; 20,000,000 shares authorized; Series B shares issued and outstanding - 0 in 2015 and 13,750 in 2014; per share redemption of \$1,000 for total liquidation preference of \$13,750	-	13,666
Common stock, no par value; shares authorized - 30,000,000 shares; issued and outstanding 4,783,170 in 2015 and 4,778,370 in 2014	36,698	36,646
Retained earnings	19,410	16,560
Accumulated other comprehensive income	<u>881</u>	<u>708</u>
Total shareholders' equity	<u>56,989</u>	<u>67,580</u>
Total liabilities and shareholders' equity	<u>\$ 505,564</u>	<u>\$ 459,675</u>

The accompanying notes are an integral part of these unaudited consolidated financial statements.

**SUMMIT STATE BANK AND SUBSIDIARY**  
**CONSOLIDATED STATEMENTS OF INCOME**  
(In thousands except earnings per share data)

	<u>Three Months Ended</u>		<u>Nine Months Ended</u>	
	<u>September 30, 2015</u> <u>(unaudited)</u>	<u>September 30, 2014</u> <u>(unaudited)</u>	<u>September 30, 2015</u> <u>(unaudited)</u>	<u>September 30, 2014</u> <u>(unaudited)</u>
Interest income:				
Interest and fees on loans	\$ 3,766	\$ 3,612	\$ 10,615	\$ 10,614
Interest on federal funds sold	1	1	2	2
Interest on investment securities and deposits in banks	917	926	2,816	2,778
Dividends on FHLB stock	67	49	267	135
Total interest income	<u>4,751</u>	<u>4,588</u>	<u>13,700</u>	<u>13,529</u>
Interest expense:				
Deposits	192	215	545	655
FHLB advances	50	43	139	124
Total interest expense	<u>242</u>	<u>258</u>	<u>684</u>	<u>779</u>
Net interest income before provision for loan losses	4,509	4,330	13,016	12,750
Provision for loan losses	-	-	(800)	(400)
Net interest income after provision for loan losses	<u>4,509</u>	<u>4,330</u>	<u>13,816</u>	<u>13,150</u>
Non-interest income:				
Service charges on deposit accounts	188	159	525	445
Rental income	133	130	399	392
Net securities gain	55	60	108	73
Net gain on other real estate owned	-	-	1,125	73
Loan servicing, net	2	3	6	9
Other income	1	188	119	403
Total non-interest income	<u>379</u>	<u>540</u>	<u>2,282</u>	<u>1,395</u>
Non-interest expense:				
Salaries and employee benefits	1,499	1,412	4,217	4,152
Occupancy and equipment	327	383	976	996
Other expenses	886	1,060	2,831	3,144
Total non-interest expense	<u>2,712</u>	<u>2,855</u>	<u>8,024</u>	<u>8,292</u>
Income before provision for income taxes	2,176	2,015	8,074	6,253
Provision for income taxes	896	832	3,328	2,578
Net income	<u>\$ 1,280</u>	<u>\$ 1,183</u>	<u>\$ 4,746</u>	<u>\$ 3,675</u>
Less: preferred dividends	23	34	92	103
Net income available for common stockholders	<u>\$ 1,257</u>	<u>\$ 1,149</u>	<u>\$ 4,654</u>	<u>\$ 3,572</u>
Basic earnings per common share	\$ 0.26	\$ 0.24	\$ 0.97	\$ 0.75
Diluted earnings per common share	\$ 0.26	\$ 0.24	\$ 0.96	\$ 0.74
Basic weighted average shares of common stock outstanding	4,783	4,778	4,783	4,778
Diluted weighted average shares of common stock outstanding	4,838	4,834	4,838	4,827

The accompanying notes are an integral part of these unaudited consolidated financial statements.

**SUMMIT STATE BANK AND SUBSIDIARY**  
**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

(In thousands)

	Nine Months Ended	
	September 30, 2015 (unaudited)	September 30, 2014 (unaudited)
Net income	\$ 4,746	\$ 3,675
Change in securities available-for-sale:		
Unrealized holding gains (losses) on available-for-sale securities arising during the period	407	3,691
Reclassification adjustment for (gains) realized in net income on available-for-sale securities	(108)	(73)
Net unrealized gains (losses), before tax	299	3,618
Income tax (expense) benefit	(126)	(1,519)
Total other comprehensive income (loss), net of tax	173	2,099
Comprehensive income	\$ 4,919	\$ 5,774

The accompanying notes are an integral part of these unaudited consolidated financial statements.

SUMMIT STATE BANK AND SUBSIDIARY  
**CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY**  
For the Nine Months Ended September 30, 2015 (Unaudited) and the Year Ended December 31, 2014  
(In thousands except per share data)

	Preferred Stock	Common Stock		Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total Shareholders' Equity
		Shares	Amount			
Balance, January 1, 2014	\$ 13,666	4,778	\$ 36,608	\$ 13,316	\$ (1,960)	\$ 61,630
Net income				5,485		5,485
Other comprehensive income					2,668	2,668
Stock-based compensation expense			34			34
Preferred stock dividends				(138)		(138)
Exercise of stock options		-	4			4
Cash dividends - \$0.44 per share				(2,103)		(2,103)
Balance, December 31, 2014	13,666	4,778	36,646	16,560	708	67,580
Net income				4,746		4,746
Other comprehensive income					173	173
Stock-based compensation expense			18			18
Retirement of preferred stock, net of issuance costs	(13,666)			(84)		(13,750)
Preferred stock dividends				(92)		(92)
Exercise of stock options		5	34			34
Cash dividends - \$0.36 per share				(1,720)		(1,720)
Balance, September 30, 2015	\$ -	4,783	\$ 36,698	\$ 19,410	\$ 881	\$ 56,989

The accompanying notes are an integral part of these unaudited consolidated financial statements.

**SUMMIT STATE BANK AND SUBSIDIARY  
CONSOLIDATED STATEMENTS OF CASH FLOWS**

(In thousands)	<b>Nine Months Ended September 30</b>	
	<b>2015</b>	<b>2014</b>
	<b>(unaudited)</b>	<b>(unaudited)</b>
Cash flows from operating activities:		
Net income	\$ 4,746	\$ 3,675
Adjustments to reconcile net income to net cash from operating activities:		
Depreciation and amortization	292	319
Securities amortization and accretion, net	431	478
Net change in deferred loan fees	(121)	399
Provision for loan losses	(800)	(400)
Net gain on other real estate owned	(1,125)	(73)
Net securities gains	(108)	(73)
Net change in accrued interest receivable and other assets	(300)	1,178
Net change in accrued interest payable and other liabilities	1,133	(952)
Stock-based compensation expense	18	28
Net cash from operating activities	4,166	4,579
Cash flows from investing activities:		
Net change in time deposits with banks	496	745
Purchases of held-to-maturity investment securities	(986)	(3,946)
Purchases of available-for-sale investment securities	(10,999)	(8,916)
Proceeds from sales of available-for-sale investment securities	3,489	1,070
Proceeds from calls of held-to-maturity investment securities	5,000	5,558
Proceeds from calls and maturities of available-for-sale investment securities	6,498	5,399
Purchase of Federal Home Loan Bank stock	-	(123)
Net change in loans	(46,931)	(3,141)
Purchases of bank premises and equipment, net	(80)	(694)
Proceeds on sale of other real estate owned	2,501	793
Net cash used in investing activities	(41,012)	(3,255)

(Continued)

**SUMMIT STATE BANK AND SUBSIDIARY  
CONSOLIDATED STATEMENTS OF CASH FLOWS**

	<b>Nine Months Ended September 30</b>	
(In thousands)	<b>2015</b>	<b>2014</b>
	<b>(unaudited)</b>	<b>(unaudited)</b>
<b>Cash flows from financing activities:</b>		
Net change in demand, savings and money market deposits	20,808	20,521
Net change in certificates of deposit	17,539	3,107
Net change in FHLB advances	17,000	(17,500)
Retirement of preferred stock	(13,750)	-
Dividends paid on common stock	(1,720)	(1,577)
Dividends paid on preferred stock	(92)	(103)
Proceeds from exercise of stock options	34	4
Net cash from financing activities	39,819	4,452
Net change in cash and cash equivalents	2,973	5,776
Cash and cash equivalents at beginning of year	23,313	16,128
Cash and cash equivalents at end of period	\$ 26,286	\$ 21,904
<b>Supplemental disclosure of cash flow information:</b>		
Cash paid during the period for:		
Interest	\$ 680	\$ 789
Income taxes	\$ 2,730	\$ 2,310
Noncash investing activities:		
Financing of other real estate owned sale	\$ 2,675	\$ -

The accompanying notes are an integral part of these unaudited consolidated financial statements.



**SUMMIT STATE BANK AND SUBSIDIARY**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)**

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

*General*

On January 15, 1999, Summit State Bank (the “Bank” or “the Bank”) received authority to transact business as a California state-chartered commercial bank and is subject to regulation, supervision and examination by the State of California Department of Business Oversight and the Federal Deposit Insurance Corporation. The Bank was incorporated on December 20, 1982 under the name Summit Savings. The Bank provides a variety of banking services to individuals and businesses in its primary service area of Sonoma County, California. The Bank's branch locations include Santa Rosa, Petaluma, Rohnert Park and Healdsburg. The Bank offers depository and lending services primarily to meet the needs of its business and individual clientele. These services include a variety of transaction, money market, savings and time deposit account alternatives. The Bank's lending activities are directed primarily towards commercial real estate, construction and business loans. The Bank utilizes its subsidiary Alto Service Corporation for its deed of trust services.

The consolidated financial statements as of September 30, 2015 and for the three and nine months ended September 30, 2015 and 2014 are unaudited. In the opinion of management, these unaudited consolidated financial statements contain all adjustments, consisting only of normal recurring accruals necessary to present fairly the consolidated financial statements of the Bank.

The accompanying unaudited consolidated interim financial statements have been prepared in accordance with U.S. Generally Accepted Accounting Principles for interim financial information and Article 8 of Regulation S-X of the Securities and Exchange Commission. Operating results for the three and nine months ended September 30, 2015 are not necessarily indicative of the results that may be expected for the year ending December 31, 2015. These unaudited consolidated financial statements do not include all disclosures associated with the Bank's consolidated annual financial statements and notes thereto and accordingly, should be read in conjunction with the consolidated financial statements and notes thereto included in the Bank's Annual Report for the year ended December 31, 2014 on Form 10-K on file with the FDIC (Form 10-K may be found at [www.summitstatebank.com](http://www.summitstatebank.com)).

The accompanying accounting and reporting policies of the Bank and subsidiary conform to U.S. Generally Accepted Accounting Principles and prevailing practices within the banking industry.

*Principles of Consolidation*

The consolidated financial statements include the accounts of the Bank and its wholly-owned subsidiary, Alto Service Corporation. All significant intercompany accounts and transactions have been eliminated in consolidation.

*Use of Estimates*

The preparation of financial statements in conformity with U.S. Generally Accepted Accounting Principles requires management to make estimates and assumptions. These estimates and assumptions affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from these estimates. The allowance for loan losses, goodwill impairment, valuation of other real estate owned, and fair values of investment securities are particularly subject to change.

*Earnings Per Common Share*

Basic earnings per common share (EPS), which excludes dilution, is computed by dividing income available to common shareholders by the weighted-average number of common shares outstanding for the period. Diluted earnings per common share reflects the potential dilution that could occur if securities or other contracts to issue common stock, such as stock options, result in the issuance of common stock which share in the earnings of the Bank. Stock Options for 54,000 shares of common stock for the three and nine months ended September 30, 2015

were not considered in computing diluted earnings per share because they were anti-dilutive. Stock options for 61,000 and 68,000 shares of common stock for the three and nine months ended September 30, 2014 were not considered in computing diluted earnings per share because they were anti-dilutive.

The factors used in the earnings per common share computation follow:

(in thousands except earnings per share)	Three Months Ended		Nine Months Ended	
	September 30, 2015	September 30, 2014	September 30, 2015	September 30, 2014
<b>Basic</b>				
Net income available for common shareholders	\$ 1,257	\$ 1,149	\$ 4,654	\$ 3,572
Weighted average common shares outstanding	4,783	4,778	4,783	4,778
Basic earnings per common share	\$ 0.26	\$ 0.24	\$ 0.97	\$ 0.75
<b>Diluted</b>				
Net income available for common shareholders	\$ 1,257	\$ 1,149	\$ 4,654	\$ 3,572
Weighted average common shares outstanding for basic earnings per common share	4,783	4,778	4,783	4,778
Add: Dilutive effects of assumed exercises of stock options	55	56	55	49
Average shares and dilutive potential common shares	4,838	4,834	4,838	4,827
Diluted earnings per common share	\$ 0.26	\$ 0.24	\$ 0.96	\$ 0.74

## 2. REGULATORY CAPITAL

The Bank's actual and required capital amounts and ratios consisted of the following:

(in thousands)	September 30, 2015	
	Amount	Ratio
<b>Common Equity Tier 1 Capital Ratio</b>		
Summit State Bank	\$ 51,989	13.7%
Minimum requirement for "Well-Capitalized" institution	\$ 24,728	6.5%
Minimum regulatory requirement	\$ 17,120	4.5%
<b>Tier 1 Capital Ratio</b>		
Summit State Bank	\$ 51,989	13.7%
Minimum requirement for "Well-Capitalized" institution	\$ 30,435	8.0%
Minimum regulatory requirement	\$ 22,826	6.0%
<b>Total Capital Ratio</b>		
Summit State Bank	\$ 56,683	14.9%
Minimum requirement for "Well-Capitalized" institution	\$ 38,044	10.0%
Minimum regulatory requirement	\$ 30,435	8.0%
<b>Tier 1 Leverage Ratio</b>		
Summit State Bank	\$ 51,989	10.6%
Minimum requirement for "Well-Capitalized" institution	\$ 24,541	5.0%
Minimum regulatory requirement	\$ 19,633	4.0%

## Preferred Stock

On August 4, 2011, the Bank issued 13,750 shares for \$13,750,000 of Fixed Rate Non-cumulative Perpetual Preferred Stock, Series B (the "Preferred Stock"), which was recorded net of \$84,000 in issuance costs. The Preferred Stock was issued under the Small Business Lending Fund (SBLF) of the U.S. Department of the Treasury and had an initial non-cumulative dividend rate of 5% per annum. The dividend rate was adjusted lower each quarter depending on increases that occur in qualifying loans as described in the SBLF program. The Preferred Stock was redeemed at par value of \$13,750,000 on August 31, 2015.

### 3. STOCK OPTIONS

The shareholders approved the 2013 Equity Incentive Plan ("Plan") on July 29, 2013. The Plan allows for various equity-based incentives such as stock appreciation rights, restricted stock awards, stock grants and qualified performance-based awards. The Plan reserved 150,000 shares of common stock for issuance to Bank employees and directors. The Plan requires that the option exercise price may not be less than the fair market value of the stock at the date the option is granted. Option awards have vesting periods of 5 years unless otherwise approved by the Board of Directors. The option expiration dates are determined by the Board of Directors, but may not be later than ten years from the date of grant. No options were granted during the three and nine months ended September 30, 2015 and September 30, 2014. As of September 30, 2015, 150,000 shares remain available for future grants under the Plan. There were 109,116 options outstanding as of September 30, 2015, which includes options granted under prior stock option plans.

### 4. COMMITMENTS AND CONTINGENCIES

The Bank is subject to legal proceedings and claims which arise in the ordinary course of business. In the opinion of management, the amount of ultimate liability with respect to such actions will not materially affect the consolidated financial condition or results of operations of the Bank.

The Bank's business activity is primarily with clients located within Northern California. Although the Bank has a diversified loan portfolio, a significant portion of its clients' ability to repay loans is dependent upon the real estate market and various economic factors within Sonoma County. Generally, loans are secured by various forms of collateral. The Bank's loan policy requires sufficient collateral to be obtained as necessary to meet the Bank's relative risk criteria for each borrower. The Bank's collateral for the lending portfolio consists primarily of real estate, accounts receivable, inventory and other financial instruments. At September 30, 2015, loans with real estate collateral approximate \$272,162,000 or 81% of the loan portfolio.

The Bank is a party to financial instruments with off-balance-sheet risk in the normal course of business in order to meet the financing needs of its clients and to reduce its own exposure to fluctuations in interest rates. These financial instruments consist of commitments to extend credit and standby letters of credit. These instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized on the consolidated balance sheets. The Bank's exposure to credit loss in the event of nonperformance by the other party for commitments to extend credit and standby letters of credit is represented by the contractual amount of those instruments. The Bank uses the same credit policies in making commitments and standby letters of credit as it does for loans included on the consolidated balance sheet.

Commitments to extend credit, which totaled \$37,836,000 and \$26,374,000 at September 30, 2015 and December 31, 2014, are agreements to lend to a client as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since some of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Bank evaluates each client's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Bank upon extension of the credit, is based on management's credit evaluation of the borrower. Collateral held relating to these commitments varies, but may include securities, equipment, accounts receivable, inventory and deeds of trust on residential real estate and owner-occupied or income-producing commercial properties.

Standby letters of credit, which totaled \$1,937,000 and \$1,389,000 at September 30, 2015 and December 31, 2014, are conditional commitments issued by the Bank to guarantee the performance of a client to a first party. The credit risk involved in issuing standby letters of credit is essentially the same as that involved in extending loans to clients. The fair value of the liability related to these standby letters of credit, which represents the fees received for issuing the guarantees, was not significant at September 30, 2015 and December 31, 2014. The Bank recognizes these fees as revenue over the term of the commitment or when the commitment is used.

## 5. FAIR VALUE

Accounting standards establish a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The standard describes three levels of inputs that may be used to measure fair value:

Level 1: Quoted prices (unadjusted) for identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.

Level 2: Significant other observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data.

Level 3: Significant unobservable inputs that reflect a reporting entity's own assumptions about the assumptions that market participants would use in pricing an asset or liability.

The fair values of most securities available for sale are determined by matrix pricing, which is a mathematical technique widely used in the industry to value debt securities without relying exclusively on quoted prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted securities (Level 2 inputs).

The fair value of impaired loans that are collateral dependent are generally based on real estate appraisals. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are usually significant and typically result in a Level 3 classification of the inputs for determining fair value.

Estimated fair values are disclosed for financial instruments for which it is practicable to estimate fair value. These estimates are made at a specific point in time based on relevant market data and information about the financial instruments. These estimates do not reflect any premium or discount that could result from offering the Bank's entire holdings of a particular financial instrument for sale at one time, nor do they attempt to estimate the value of anticipated future business related to the instruments. In addition, the tax ramifications related to the realization of unrealized gains and losses can have a significant effect on fair value estimates and have not been considered in any of these estimates.

Because no active market exists for a significant portion of the Bank's financial instruments, fair value estimates are based on judgments regarding current economic conditions, risk characteristics of various financial instruments and other factors. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and therefore cannot be determined with precision. Changes in assumptions could significantly affect the fair values presented.

The following methods and assumptions were used by the Bank to estimate the fair value of its financial instruments at September 30, 2015 and December 31, 2014:

Cash and cash equivalents: For cash and cash equivalents consisting of cash, due from banks and federal funds sold, the carrying amount is estimated to be fair value.

Time deposits with banks: Fair values for fixed-rate certificates of deposit with banks are estimated using a discounted cash flow analysis using interest rates being offered at each reporting date for certificates with similar maturities.

Investment securities: For investment securities, fair values are based on quoted market prices, where available. If quoted market prices are not available, fair values are estimated using quoted market prices for similar securities and indications of value provided by brokers. The carrying amount of accrued interest receivable approximates its fair value.

Loans, net of allowance: For variable-rate loans that reprice frequently with no significant change in credit risk, fair values are based on carrying values. Fair values for other loans are estimated using discounted cash flow analyses, using interest rates being offered at each reporting date for loans with similar terms to borrowers of comparable creditworthiness (without considering widening credit spreads due to market illiquidity). The allowance for loan losses is considered to be a reasonable estimate of discount for credit risk. The carrying amount of accrued interest receivable approximates its fair value.

Federal Home Loan Bank stock: Federal Home Loan Bank Stock is subject to restrictions on its transferability. It is redeemable only by the Federal Home Loan Bank at par value of \$100 per share.

Deposits: The fair values for demand deposits are, by definition, equal to the amount payable on demand at the reporting date represented by their carrying amount. Fair values for fixed-rate certificates of deposit are estimated using a discounted cash flow analysis using interest rates being offered at each reporting date for certificates with similar remaining maturities. The carrying amount of accrued interest payable approximates its fair value.

Short-term borrowings and long-term debt: The fair values of fixed rate borrowings are estimated using a discounted cash flow analysis that applies interest rates being offered on similar debt instruments. The fair values of variable rate borrowings are based on carrying value. The carrying amount of accrued interest payable approximates its fair value.

Commitments to fund loans/standby letters of credit: The fair values of commitments are estimated using the fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the present creditworthiness of the counterparties. The differences between the carrying value of commitments to fund loans or standby letters of credit and their fair value are not significant and, therefore, are not included in the following table.

The following table presents a summary of the carrying value and fair value by level of financial instruments on the Bank's balance sheet at September 30, 2015 and December 31, 2014:

(in thousands)	September 30, 2015			December 31, 2014		
	Carrying Amount	Fair Value	Fair Value Hierarchy	Carrying Amount	Fair Value	Fair Value Hierarchy
<b>Financial assets:</b>						
Cash and cash equivalents	\$ 26,286	\$ 26,286	Level 1	\$ 21,313	\$ 21,313	Level 1
Time deposits with banks	744	744	Level 2	1,240	1,240	Level 2
Investment securities - held-to-maturity	5,987	5,858	Level 2	9,977	9,977	Level 2
Investment securities - available-for-sale	125,681	125,681	Level 2	124,723	124,723	Level 2
Loans, net of allowance	330,325	343,122	Level 3	279,798	297,856	Level 3
Investment in FHLB stock	2,701	2,701	Level 2	2,701	2,701	Level 2
Accrued interest receivable	2,054	2,054	Level 2	2,010	2,010	Level 2
<b>Financial liabilities:</b>						
Deposits	\$ 393,606	\$ 393,575	Level 2	\$ 355,259	\$ 355,403	Level 2
FHLB advances	52,000	52,031	Level 2	35,000	35,068	Level 2
Accrued interest payable	40	40	Level 2	36	36	Level 2

## Assets Measured on a Recurring Basis

Assets measured at fair value on a recurring basis are summarized below:

Fair Value Measurements at September 30, 2015 (In thousands)				
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<u>September 30, 2015</u>				
Assets:				
Securities available-for-sale:				
U.S. Treasuries	\$ 8,015	\$ -	\$ 8,015	\$ -
Government agencies	75,287	-	75,287	-
Mortgage-backed securities - residential	4,047	-	4,047	-
Corporate debt	38,332	-	38,332	-
Municipal securities	-	-	-	-
Total securities available-for-sale	<u>\$ 125,681</u>	<u>\$ -</u>	<u>\$ 125,681</u>	<u>\$ -</u>
Fair Value Measurements at December 31, 2014 (In thousands)				
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<u>December 31, 2014</u>				
Assets:				
Securities available-for-sale:				
U.S. Treasuries	\$ 7,999	\$ -	\$ 7,999	\$ -
Government agencies	69,815	-	69,815	-
Mortgage-backed securities - residential	4,394	-	4,394	-
Corporate debt	42,515	-	42,515	-
Municipal securities	-	-	-	-
Total securities available-for-sale	<u>\$ 124,723</u>	<u>\$ -</u>	<u>\$ 124,723</u>	<u>\$ -</u>

There were no significant transfers between Level 1 and Level 2 or Level 3 during the three and nine months ended September 30, 2015 or the year ended December 31, 2014.

## Assets Measured on a Non-Recurring Basis

Assets measured at fair value on a non-recurring basis are summarized below:

		Fair Value Measurements at September 30, 2015 (In thousands)			
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	
September 30, 2015					
Assets:					
Commercial & agricultural	\$ -	\$ -	\$ -	\$ -	
Real estate - commercial	5,815	-	-	5,815	
Real estate - construction and land	-	-	-	-	
Real estate - single family	-	-	-	-	
Real estate - multifamily	-	-	-	-	
Consumer & lease financing	-	-	-	-	
Impaired loans with specific loss allocations	<u>\$ 5,815</u>	<u>-</u>	<u>-</u>	<u>\$ 5,815</u>	

  

		Fair Value Measurements at December 31, 2014 (In thousands)			
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	
December 31, 2014					
Assets:					
Commercial & agricultural	\$ -	\$ -	\$ -	\$ -	
Real estate - commercial	6,179	-	-	6,179	
Real estate - construction and land	-	-	-	-	
Real estate - single family	-	-	-	-	
Real estate - multifamily	-	-	-	-	
Consumer & lease financing	-	-	-	-	
Impaired loans with specific loss allocations	<u>\$ 6,179</u>	<u>-</u>	<u>-</u>	<u>\$ 6,179</u>	

The following tables present the valuation techniques covering the majority of Level 3 non-recurring fair value measurements and the most significant unobservable inputs used in those measurements as of September 30, 2015 and December 31, 2014:

(in thousands)

As of September 30, 2015	Fair Value	Methodology	Input	Low	High	Weighted average
Real estate loans	\$ 5,815	Price-based	Appraised value	\$ 5,815	\$ 5,815	\$ 5,815

  

As of December 31, 2014	Fair Value	Methodology	Input	Low	High	Weighted average
Real estate loans	\$ 6,179	Price-based	Appraised value	\$ 365	\$ 5,814	\$ 3,090

Fair value estimates are determined as of a specific point in time utilizing quoted market prices, where available, or various assumptions and estimates. As the assumptions and estimates change, the fair value of the financial instruments will change. The use of assumptions and various techniques, as well as the absence of secondary markets for certain financial instruments, will likely reduce the comparability of value disclosures between companies.

Impaired loans are valued at the fair value less estimated disposal costs of collateral. Impaired loans with specific loss allocations had a principal balance of \$6,506,000 with a valuation allowance of \$691,000 at September 30,

2015. Impaired loans with specific loss allocations had a principal balance of \$7,674,000 with a valuation allowance of \$1,495,000 at December 31, 2014.

## 6. INVESTMENT SECURITIES

The amortized costs and estimated fair value of investment securities are reflected in the tables below:

(in thousands)	September 30, 2015			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Held-to-maturity:				
Government agencies	\$ 5,987	\$ -	\$ (129)	\$ 5,858
Available-for-sale:				
U.S. Treasuries	\$ 8,007	\$ 8	\$ -	\$ 8,015
Government agencies	75,043	837	(593)	75,287
Mortgage-backed securities - residential	4,004	43	-	4,047
Corporate debt	37,107	1,391	(166)	38,332
Municipal securities	-	-	-	-
Total available-for-sale	124,161	2,279	(759)	125,681
Total investment securities	<u>\$ 130,148</u>	<u>\$ 2,279</u>	<u>\$ (888)</u>	<u>\$ 131,539</u>
	December 31, 2014			
(in thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Held-to-maturity:				
Government agencies	\$ 9,977	\$ 18	\$ (219)	\$ 9,776
Available-for-sale:				
U.S. Treasuries	\$ 8,011	\$ -	\$ (12)	\$ 7,999
Government agencies	70,016	787	(988)	69,815
Mortgage-backed securities - residential	4,350	44	-	4,394
Corporate debt	41,126	1,611	(222)	42,515
Municipal securities	-	-	-	-
Total available-for-sale	123,503	2,442	(1,222)	124,723
Total investment securities	<u>\$ 133,480</u>	<u>\$ 2,460</u>	<u>\$ (1,441)</u>	<u>\$ 134,499</u>

The activity related to recorded gains and losses of investment securities is reflected in the table below:

(in thousands)	Three Months Ended		Nine Months End	
	September 30, 2015	September 30, 2014	September 30, 2015	September 30, 2014
Proceeds from sales	\$ 2,972	\$ 570	\$ 3,489	\$ 1,070
Proceeds from calls	254	231	2,705	476
Gross realized gains on sales and calls	116	60	169	90
Gross realized losses on sales and calls	(61)	-	(61)	(17)

There were 18 investment securities in a continuous unrealized loss position greater than 12 months at September 30, 2015. At September 30, 2015, the Bank held 42 investment securities which were in an unrealized loss position for less than twelve months. The interest rate volatility during the year resulted in many investment securities ending the period in an unrealized loss position. Management periodically evaluates each investment security for other-than-temporary impairment (OTTI), relying primarily on industry analyst reports and observation of market conditions and interest rate fluctuations. All of the impairment appearing in the investment securities portfolio valuations is considered to be temporary. The measured impairment in the securities values is primarily attributable to changes in short term interest rates, market shifts of the Treasury yield curve and other variable market and economic conditions. The measured impairment in securities values did not result from any significant or persistent deterioration in the underlying credit quality of any of the investments. The securities portfolio consists primarily of



debt securities with non-contingent contractual cash flows. Full realization of the principal balance is expected upon final maturity. Management has the intent and ability to hold the securities until recovery of the carrying value, which could be at the final maturity. There were no OTTI recorded in 2015 or 2014.

Investment securities with unrealized losses are summarized and classified according to the duration of the loss period as follows:

September 30, 2015						
(in thousands)	Less than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Debt securities:						
Held-to-maturity:						
Government agencies	\$ 3,978	\$ (10)	\$ 1,880	\$ (119)	\$ 5,858	\$ (129)
Available-for-sale:						
U.S. Treasuries	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Government agencies	29,260	(374)	15,144	(219)	44,404	(593)
Mortgage-backed securities - residential	-	-	-	-	-	-
Corporate debt	6,025	(123)	2,280	(43)	8,305	(166)
Municipal securities	-	-	-	-	-	-
Total available-for-sale	<u>35,285</u>	<u>(497)</u>	<u>17,424</u>	<u>(262)</u>	<u>52,709</u>	<u>(759)</u>
Total investment securities	<u>\$ 39,263</u>	<u>\$ (507)</u>	<u>\$ 19,304</u>	<u>\$ (381)</u>	<u>\$ 58,567</u>	<u>\$ (888)</u>

December 31, 2014						
(in thousands)	Less than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Debt securities:						
Held-to-maturity:						
Government agencies	\$ -	\$ -	\$ 7,781	\$ (219)	\$ 7,781	\$ (219)
Available-for-sale:						
U.S. Treasuries	\$ 7,999	\$ (12)	\$ -	\$ -	\$ 7,999	\$ (12)
Government agencies	7,407	(35)	46,403	(953)	53,810	(988)
Mortgage-backed securities - residential	-	-	-	-	-	-
Corporate debt	3,495	(89)	6,218	(133)	9,713	(222)
Municipal securities	-	-	-	-	-	-
Total available-for-sale	<u>18,901</u>	<u>(136)</u>	<u>52,621</u>	<u>(1,086)</u>	<u>71,522</u>	<u>(1,222)</u>
Total investment securities	<u>\$ 18,901</u>	<u>\$ (136)</u>	<u>\$ 60,402</u>	<u>\$ (1,305)</u>	<u>\$ 79,303</u>	<u>\$ (1,441)</u>

The amortized cost and estimated fair value of investment securities at September 30, 2015 by contractual maturity are shown below. Expected maturities will differ from contractual maturities because the issuers of the securities may have the right to call or prepay obligations with or without call or prepayment penalties.

(in thousands)	Held to Maturity		Available for Sale	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Within one year	\$ -	\$ -	\$ 7,139	\$ 7,153
After one year through five years	-	-	32,192	33,243
After five years through ten years	-	-	70,237	70,752
After ten years	5,987	5,858	10,589	10,486
	<u>5,987</u>	<u>5,858</u>	<u>120,157</u>	<u>121,634</u>
Investment securities not due at a single maturity date:				
Mortgage-backed securities - residential	-	-	4,004	4,047
	<u>\$ 5,987</u>	<u>\$ 5,858</u>	<u>\$ 124,161</u>	<u>\$ 125,681</u>

## 7. LOANS

Outstanding loans are summarized as follows:

(in thousands)	September 30, 2015	December 31, 2014
Commercial & agricultural	\$ 79,517	\$ 68,371
Real estate - commercial	159,203	145,565
Real estate - construction and land	10,579	11,175
Real estate - single family	65,625	46,590
Real estate - multifamily	19,519	13,095
Consumer & lease financing	546	145
	<u>334,989</u>	<u>284,941</u>
Allowance for loan losses	<u>(4,664)</u>	<u>(5,143)</u>
	<u>\$ 330,325</u>	<u>\$ 279,798</u>

Changes in the allocation of allowance for loan losses by loan class for the three and nine months ended September 30, 2015 and 2014 are as follows:

(in thousands)	Three Months Ended September 30, 2015				
	Balance at June 30, 2015	Provision for loan losses	Charge-offs	Recoveries	Balance at September 30, 2015
Beginning balance:					
Commercial & agricultural	\$ 976	\$ (149)	\$ -	\$ 161	\$ 988
Real estate - commercial	1,096	-	-	-	1,096
Real estate - construction and land	187	(134)	-	-	53
Real estate - single family	296	81	-	3	380
Real estate - multifamily	15	24	-	-	39
Consumer & lease financing	4	(21)	-	23	6
Unallocated	1,903	199	-	-	2,102
Total	<u>\$ 4,477</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 187</u>	<u>\$ 4,664</u>

(in thousands)	Three Months Ended September 30, 2014				
	Balance at June 30, 2014	Provision for loan losses	Charge-offs	Recoveries	Balance at September 30, 2014
Beginning balance:					
Commercial & agricultural	\$ 559	\$ (27)	\$ -	\$ -	\$ 532
Real estate - commercial	2,565	(188)	-	-	2,377
Real estate - construction and land	369	(156)	-	-	213
Real estate - single family	275	(33)	-	4	246
Real estate - multifamily	285	(272)	-	-	13
Consumer & lease financing	11	(3)	-	3	11
Unallocated	902	679	-	-	1,581
Total	<u>\$ 4,966</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 7</u>	<u>\$ 4,973</u>

(in thousands)

Nine Months Ended September 30, 2015

	Balance at December 31, 2014	Provision for loan losses	Charge-offs	Recoveries	Balance at September 30, 2015
Beginning balance:					
Commercial & agricultural	\$ 534	\$ 293	\$ -	\$ 161	\$ 988
Real estate - commercial	1,861	(765)	-	-	1,096
Real estate - construction and land	216	(163)	-	-	53
Real estate - single family	141	106	-	133	380
Real estate - multifamily	13	26	-	-	39
Consumer & lease financing	10	(31)	(2)	29	6
Unallocated	2,368	(266)	-	-	2,102
Total	<u>\$ 5,143</u>	<u>\$ (800)</u>	<u>\$ (2)</u>	<u>\$ 323</u>	<u>\$ 4,664</u>

(in thousands)

Nine Months Ended September 30, 2014

	Balance at December 31, 2013	Provision for loan losses	Charge-offs	Recoveries	Balance at September 30, 2014
Beginning balance:					
Commercial & agricultural	\$ 562	\$ (35)	\$ -	\$ 5	\$ 532
Real estate - commercial	2,955	(517)	(76)	15	2,377
Real estate - construction and land	379	(166)	-	-	213
Real estate - single family	214	20	-	12	246
Real estate - multifamily	272	(259)	-	-	13
Consumer & lease financing	15	(9)	(5)	10	11
Unallocated	1,015	566	-	-	1,581
Total	<u>\$ 5,412</u>	<u>\$ (400)</u>	<u>\$ (81)</u>	<u>\$ 42</u>	<u>\$ 4,973</u>

The following table presents the balance in the allowance for loan losses and loan balances by class and based on impairment method as of September 30, 2015 and December 31, 2014:

September 30, 2015						
(in thousands)	Allowance for Loan Losses			Loans		
	Individually Evaluated for Impairment	Collectively Evaluated for Impairment	Total Ending Allowance Balance	Loans Individually Evaluated for Impairment	Loans Collectively Evaluated for Impairment	Total Ending Loans Balance
Commercial & agricultural	\$ 351	637	\$ 988	\$ 1,252	\$ 78,265	\$ 79,517
Real estate - commercial	340	756	1,096	8,853	150,350	159,203
Real estate - construction and land	-	53	53	2	10,577	10,579
Real estate - single family	-	380	380	1,207	64,418	65,625
Real estate - multifamily	-	39	39	173	19,346	19,519
Consumer & lease financing	-	6	6	-	546	546
Unallocated	-	2,102	2,102	-	-	-
Total	<u>\$ 691</u>	<u>\$ 3,973</u>	<u>\$ 4,664</u>	<u>\$ 11,487</u>	<u>\$ 323,502</u>	<u>\$ 334,989</u>

  

December 31, 2014						
(in thousands)	Allowance for Loan Losses			Loans		
	Individually Evaluated for Impairment	Collectively Evaluated for Impairment	Total Ending Allowance Balance	Loans Individually Evaluated for Impairment	Loans Collectively Evaluated for Impairment	Total Ending Loans Balance
Commercial & agricultural	\$ 359	\$ 175	\$ 534	\$ 1,328	\$ 67,043	\$ 68,371
Real estate - commercial	1,136	725	1,861	10,000	135,565	145,565
Real estate - construction and land	-	216	216	18	11,157	11,175
Real estate - single family	-	141	141	2,396	44,194	46,590
Real estate - multifamily	-	13	13	189	12,906	13,095
Consumer & lease financing	-	10	10	-	145	145
Unallocated	-	2,368	2,368	-	-	-
Total	<u>\$ 1,495</u>	<u>\$ 3,648</u>	<u>\$ 5,143</u>	<u>\$ 13,931</u>	<u>\$ 271,010</u>	<u>\$ 284,941</u>

The unallocated allowance represents temporary changes in allocations resulting from changes in loan volumes, types and quality, as well as other factors. Management assesses the unallocated amount to determine if the amount is due to other than temporary changes in these factors. The unallocated allowance relates to the trend in impaired and classified loans, the projected increase in new loans and additional allowance that may be attributed to recoveries of previously charged-off loans.

The recorded investment in the aforementioned disclosure and the next several disclosures do not include accrued interest receivable and net deferred fees because such amounts are not considered material. Accrued interest receivable for the total loan portfolio was \$1,146,000 and \$1,008,000 and net deferred loan fees was \$101,000 and \$338,000 as of September 30, 2015 and December 31, 2014.

The following table presents impaired loans individually evaluated for impairment by class of loans:

(in thousands)	Commercial & agricultural	Real estate - commercial	Real estate - construction and land	Real estate - single family	Real estate - multifamily	Consumer & lease financing	Total
<u>September 30, 2015</u>							
<b>Recorded investment in impaired loans:</b>							
With no related allowance recorded	\$ 901	\$ 2,698	\$ 2	\$ 1,207	\$ 173	\$ -	\$ 4,981
With an allowance recorded	<u>351</u>	<u>6,155</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>6,506</u>
Total recorded investment in impaired loans	<u>\$ 1,252</u>	<u>\$ 8,853</u>	<u>\$ 2</u>	<u>\$ 1,207</u>	<u>\$ 173</u>	<u>\$ -</u>	<u>\$ 11,487</u>
<b>Unpaid principal balance of impaired loans:</b>							
With no related allowance recorded	\$ 901	\$ 2,698	\$ 2	\$ 1,234	\$ 173	\$ -	\$ 5,008
With an allowance recorded	<u>351</u>	<u>6,155</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>6,506</u>
Total unpaid principal balance of impaired loans	<u>\$ 1,252</u>	<u>\$ 8,853</u>	<u>\$ 2</u>	<u>\$ 1,234</u>	<u>\$ 173</u>	<u>\$ -</u>	<u>\$ 11,514</u>
Allowance for loan losses allocation	\$ 351	\$ 340	\$ -	\$ -	\$ -	\$ -	\$ 691
Average recorded investment in impaired loans during the quarter ended September 30, 2015	1,267	8,876	5	1,211	178	-	11,537
Interest income recognized on impaired loans during the quarter ended September 30, 2015	12	103	-	13	-	-	128
Average recorded investment in impaired loans during the nine months ended September 30, 2015	1,303	9,241	11	1,607	182	-	12,344
Interest income recognized on impaired loans during the nine months ended September 30, 2015	35	304	1	46	-	-	386
<u>December 31, 2014</u>							
<b>Recorded investment in impaired loans:</b>							
With no related allowance recorded	\$ 969	\$ 2,685	\$ 18	\$ 2,396	\$ 189	\$ -	\$ 6,257
With an allowance recorded	<u>359</u>	<u>7,315</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>7,674</u>
Total recorded investment in impaired loans	<u>\$ 1,328</u>	<u>\$ 10,000</u>	<u>\$ 18</u>	<u>\$ 2,396</u>	<u>\$ 189</u>	<u>\$ -</u>	<u>\$ 13,931</u>
<b>Unpaid principal balance of impaired loans:</b>							
With no related allowance recorded	\$ 969	\$ 2,685	\$ 18	\$ 3,124	\$ 189	\$ -	\$ 6,985
With an allowance recorded	<u>359</u>	<u>7,315</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>7,674</u>
Total unpaid principal balance of impaired loans	<u>\$ 1,328</u>	<u>\$ 10,000</u>	<u>\$ 18</u>	<u>\$ 3,124</u>	<u>\$ 189</u>	<u>\$ -</u>	<u>\$ 14,659</u>
Allowance for loan losses allocation	\$ 359	\$ 1,136	\$ -	\$ -	\$ -	\$ -	\$ 1,495
<u>September 30, 2014</u>							
Allowance for loan losses allocation	\$ 361	\$ 1,166	\$ -	\$ -	\$ -	\$ -	\$ 1,527
Average recorded investment in impaired loans during the quarter ended September 30, 2014	1,368	10,935	22	2,429	195	-	14,949
Interest income recognized on impaired loans during the quarter ended September 30, 2014	12	75	1	22	-	-	110
Average recorded investment in impaired loans during the nine months ended September 30, 2014	1,528	11,518	25	2,466	201	-	15,738
Interest income recognized on impaired loans during the nine months ended September 30, 2014	44	233	1	64	-	-	342

The following table presents the recorded investment in nonaccrual loans and loans past due over 90 days still accruing by class of loans as of September 30, 2015 and December 31, 2014:

(in thousands)	September 30, 2015		December 31, 2014	
	Nonaccrual	Loans Past Due Over 90 Days Still Accruing	Nonaccrual	Loans Past Due Over 90 Days Still Accruing
Commercial & agricultural	\$ 358	\$ -	\$ 391	\$ -
Real estate - commercial	506	-	855	-
Real estate - construction and land	-	-	-	-
Real estate - single family	358	-	380	-
Real estate - multifamily	173	-	189	-
Consumer & lease financing	-	-	-	-
Total	<u>\$ 1,395</u>	<u>\$ -</u>	<u>\$ 1,815</u>	<u>\$ -</u>

The following table presents the aging of the recorded investment in past due loans as of September 30, 2015 by class of loans:

(in thousands)	30 - 59 Days Past Due	60 - 89 Days Past Due	Greater Than 90 Days Past Due	Total Past Due	Loans Not Past Due	Total
Commercial & agricultural	\$ -	\$ -	\$ -	\$ -	\$ 79,517	\$ 79,517
Real estate - commercial	-	-	226	226	158,977	159,203
Real estate - construction and land	-	-	-	-	10,579	10,579
Real estate - single family	114	330	-	444	65,181	65,625
Real estate - multifamily	-	-	-	-	19,519	19,519
Consumer & lease financing	-	-	-	-	546	546
Total	<u>\$ 114</u>	<u>\$ 330</u>	<u>\$ 226</u>	<u>\$ 670</u>	<u>\$ 334,319</u>	<u>\$ 334,989</u>

The following table presents the aging of the recorded investment in past due loans as of December 31, 2014 by class of loans:

(in thousands)	30 - 59 Days Past Due	60 - 89 Days Past Due	Greater Than 90 Days Past Due	Total Past Due	Loans Not Past Due	Total
Commercial & agricultural	\$ 258	\$ -	\$ -	\$ 258	\$ 68,113	\$ 68,371
Real estate - commercial	-	-	551	551	145,014	145,565
Real estate - construction and land	-	-	-	-	11,175	11,175
Real estate - single family	352	343	42	737	45,853	46,590
Real estate - multifamily	189	-	-	189	12,906	13,095
Consumer & lease financing	-	-	-	-	145	145
Total	<u>\$ 799</u>	<u>\$ 343</u>	<u>\$ 593</u>	<u>\$ 1,735</u>	<u>\$ 283,206</u>	<u>\$ 284,941</u>

A loan is considered past due if a scheduled payment of interest or principal that is due is unpaid for 30 days or more.

### **Troubled Debt Restructurings**

From time to time, the Bank may agree to modify the contractual terms of a borrower's loan. In cases where such modifications represent a concession to a borrower experiencing financial difficulty, the modification is considered a troubled debt restructuring ("TDR"). At September 30, 2015 and December 31, 2014, TDR loans totaled \$3,916,000 and \$6,209,000 which are included in the impaired loan disclosures above. The total TDRs includes \$330,000 and \$654,000 that are also included in nonperforming nonaccrual loans at September 30, 2015 and December 31, 2014. TDRs had specific loss allocations of \$0, \$747,000 and \$762,000 as of September 30, 2015, December 31, 2014 and September 30, 2014.

During the three and nine months ended September 30, 2015 and 2014, there were no loans modified as troubled debt restructurings. There were no loans modified as troubled debt restructurings for which there was a payment default within twelve months following the modification during the three and nine months ended September 30, 2015 and 2014. A loan is considered to be in payment default once it is 90 days contractually past due under the modified terms.

In order to determine whether a borrower is experiencing financial difficulty, an evaluation is performed of the probability that the borrower will be in payment default on any of its debt in the foreseeable future without the modification. This evaluation is performed under the Bank's internal underwriting policy.

### **Credit Quality Indicators**

The Bank categorizes loans into risk categories based on relevant information about the ability of borrowers to service their debt such as: current financial information, historical payment experience, credit documentation, public information, and current economic trends, among other factors. The Bank analyzes loans individually by classifying the loans as to credit risk. This analysis is performed on a quarterly basis for loans in excess of \$250,000. Smaller balances are graded at origination and updated based on payment status and other information obtained from borrowers. The Bank uses the following definitions for risk ratings:

**PASS** - Loans not meeting any of the three criteria below that are analyzed individually as part of the above described process are considered to be pass rated loans.

**SPECIAL MENTION** - Loans in this category are considered "criticized" from a regulatory point of view but are not considered "classified" until the risk classification becomes substandard or worse. Loans in this category represent above average risk and potential weakness which may, if not corrected, weaken the loan and threaten repayment at some future date.

**SUBSTANDARD** - Loans in this category have well defined weakness that jeopardize full repayment of the debt, although loss may not seem likely. Loss potential does not have to exist in individual loans in the Substandard classification, but will be apparent in the aggregate. Typically, these loans have not met repayment plans as agreed. The primary source of repayment may have failed to materialize; repayment may be dependent on collateral liquidation or other secondary sources. Bankrupt borrowers and those with continuously past due payments are considered substandard.

**DOUBTFUL** - Loans in this category have all the characteristics of substandard loans with the added weakness that payment in full or liquidation in full is 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 strengthening of the loan, its classification as an estimated loss is deferred until the amount of the loss may be more accurately determined.

Based on recent analysis performed, the risk category of loans by class of loans as of September 30, 2015 is as follows:

(in thousands)	<u>Pass</u>	<u>Special Mention</u>	<u>Substandard</u>	<u>Doubtful</u>	<u>Not Rated</u>	<u>Total</u>
Commercial & agricultural	\$ 74,126	\$ 2,605	\$ 2,786	\$ -	\$ -	\$ 79,517
Real estate - commercial	150,590	1,725	6,888	-	-	159,203
Real estate - construction and land	10,579	-	-	-	-	10,579
Real estate - single family	64,690	577	358	-	-	65,625
Real estate - multifamily	18,704	-	815	-	-	19,519
Consumer & lease financing	<u>546</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>546</u>
Total	<u>\$ 319,235</u>	<u>\$ 4,907</u>	<u>\$ 10,847</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 334,989</u>

Based on recent analysis performed, the risk category of loans by class of loans as of December 31, 2014 is as follows:

(in thousands)	<u>Pass</u>	<u>Special Mention</u>	<u>Substandard</u>	<u>Doubtful</u>	<u>Not Rated</u>	<u>Total</u>
Commercial & agricultural	\$ 61,683	\$ 5,636	\$ 1,052	\$ -	\$ -	\$ 68,371
Real estate - commercial	131,982	6,525	7,058	-	-	145,565
Real estate - construction and land	11,175	-	-	-	-	11,175
Real estate - single family	44,509	320	1,761	-	-	46,590
Real estate - multifamily	12,251	655	189	-	-	13,095
Consumer & lease financing	<u>145</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>145</u>
Total	<u>\$ 261,745</u>	<u>\$ 13,136</u>	<u>\$ 10,060</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 284,941</u>

## 8. OTHER REAL ESTATE OWNED

Other real estate owned (OREO) at September 30, 2015 and December 31, 2014 was \$0 and \$4,051,000. There were no sales during the three months ended September 30, 2015. There was one sale with a book value of \$4,051,000 during the nine months ended September 30, 2015, resulting in a net gain of \$1,125,000. There were no sales during the three months ended September 30, 2014. There was one sale with a book value of \$720,000 during the nine months ended September 30, 2014, resulting in a net gain of \$73,000. Rental income, net of operating expenses on OREO, was \$3,000 and \$54,000 for the three and nine months ended September 30, 2015 and was \$59,000 and \$167,000 for the three and nine months ended September 30, 2014.



## 9. FHLB ADVANCES

The Bank adjusts its level of FHLB advances to manage balance sheet liquidity. Below are the advances outstanding at September 30, 2015.

<u>Maturity</u>	<u>Amount (in thousands)</u>	<u>Rate</u>
10/1/2015	11,000	0.20%
10/8/2015	10,000	0.23%
10/9/2015	5,000	0.22%
10/30/2015	10,000	0.20%
10/30/2015	5,000	0.31%
4/14/2016	6,000	0.50%
6/27/2016	5,000	1.05%
	<u>\$ 52,000</u>	

## 10. ACCUMULATED OTHER COMPREHENSIVE INCOME

All changes in accumulated other comprehensive income are due to unrealized gains and losses on available-for-sale securities.

The following table presents activity in accumulated other comprehensive income for the nine months ended September 30, 2015:

(in thousands)		
Accumulated other comprehensive income as of December 31, 2014	\$	708
Comprehensive income three months ended March 31, 2015		805
Comprehensive (loss) three months ended June 30, 2015		(1,433)
Comprehensive income three months ended September 30, 2015		<u>801</u>
Comprehensive income nine months ended September 30, 2015		173
Accumulated other comprehensive income as of September 30, 2015	<u>\$</u>	<u>881</u>

The following table presents activity in accumulated other comprehensive income for the nine months ended September 30, 2014:

(in thousands)		
Accumulated other comprehensive (loss) as of December 31, 2013	\$	(1,960)
Comprehensive income three months ended March 31, 2014		970
Comprehensive income three months ended June 30, 2014		997
Comprehensive income three months ended September 30, 2014		<u>132</u>
Comprehensive income nine months ended September 30, 2014		2,099
Accumulated other comprehensive income as of September 30, 2014	<u>\$</u>	<u>139</u>

## 11. SUBSEQUENT EVENT

### **Dividend**

On October 21, 2015, the Board of Directors declared a \$0.12 per common share cash dividend to shareholders of record at the close of business on November 17, 2015, to be paid on November 25, 2015.

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

The following discussion provides additional information about the financial condition of the Bank at September 30, 2015 and December 31, 2014, and results of operations for the three and nine months ended September 30, 2015 and 2014. The following analysis should be read in conjunction with the consolidated financial statements of the Bank and the notes thereto appearing elsewhere in the report, which were prepared in accordance with U.S. Generally Accepted Accounting Principles. The interim financial information provided as of and for the three and nine months ended September 30, 2015 and 2014 are unaudited. In the opinion of management of the Bank, the interim financial information presented reflects all adjustments (consisting solely of normal recurring accruals) considered necessary for a fair representation of the results of such periods.

All references to yields, cost of liabilities and net interest margin are annualized for the periods discussed.

**Forward Looking Statements.** This discussion includes forward-looking statements within the meaning of the "safe harbor" provisions of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, that are based on the current beliefs of the Bank management as well as assumptions made by and information currently available to the Bank's management. When used in this discussion, the words "anticipate," "believe," "estimate," "expect," "should," "intend," "project," "may," "will," "would," variations of such words and words or phrases of similar meaning constitute forward-looking statements. Although the Bank believes that the expectations reflected in such forward-looking statements are reasonable, it can give no assurance that such expectations will prove to have been correct.

These forward-looking statements relate to, among other things, expectations regarding the business environment in which the Bank operates, projections of future performance, potential future performance, potential future credit experience, perceived opportunities in the market, and statements regarding the Bank's mission and vision. Factors which may cause actual results to vary from forward-looking statements include, but are not limited to, changes in interest rates, general economic and business conditions, changes in business strategy or development plans, changes in credit quality, the availability of capital to fund the expansion of our business, legislative and regulatory changes, government monetary and fiscal policies, real estate valuations, competition in the financial services industry, demographic changes, civil disturbances or terrorist threats or acts, or apprehension about the possible future occurrences of acts of this type, outbreak or escalation of hostilities in which the United States is involved, any declaration of war by the U.S. Congress or any other national or international calamity, crisis or emergency, and other risks referenced in this discussion.

This discussion contains certain forward-looking information about us. All statements other than statements of historical fact are forward-looking statements. Such statements involve inherent risks and uncertainties, many of which are difficult to predict and are generally beyond our control. We caution readers that a number of important factors could cause actual results to differ materially from those expressed in, implied or projected by, such forward-looking statements. Risks and uncertainties include, but are not limited to:

- lower revenues than expected;
- credit quality deterioration which could cause an increase in the provision for credit losses;
- competitive pressure among depository institutions increases significantly;
- the cost of additional capital is more than expected;
- a change in the interest rate environment reduces interest margins;
- asset/liability repricing risks and liquidity risks;
- legislative or regulatory requirements or changes adversely affecting our business;
- changes in the securities markets;
- general economic conditions, either nationally or in the market areas in which we do or anticipate doing business, are less favorable than expected;
- potential weakness of real estate collateral values;
- the economic and regulatory effects of the continuing war on terrorism and other events of war, including the wars in Iraq and Afghanistan;

- our ability to complete any future acquisitions, to successfully integrate acquired entities, or to achieve expected synergies and operating efficiencies within expected time-frames or at all;
- the integration of any future acquired businesses costs more, takes longer or is less successful than expected; and
- regulatory approvals for announced or future acquisitions cannot be obtained on the terms expected or on the anticipated schedule.

Also, other important factors that could cause actual results to differ materially from the Bank's expectations are disclosed under Item 1A. "RISK FACTORS," in our Annual Report on Form 10-K on file with the Federal Deposit Insurance Corporation ("FDIC") and below under this "MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS – *Critical Accounting Policies*" and elsewhere in this report.

If any of these risks or uncertainties materializes, or if any of the assumptions underlying such forward-looking statements proves to be incorrect, our results could differ materially from those expressed in, implied or projected by, such forward-looking statements. We assume no obligation to update such forward-looking statements.

We caution that these statements are further qualified by important factors, in addition to those under "Risk Factors" in our Annual Report on Form 10-K and elsewhere in this report, which could cause actual results to differ significantly from those in the forward-looking statements, including, among other things, economic conditions and other risks.

Forward-looking statements are not guarantees of performance. By their nature, they involve risks, uncertainties and assumptions. Our future results and shareholder values may differ significantly from those expressed in these forward-looking statements. You are cautioned not to put undue reliance on any forward-looking statement. Any such statement speaks only as of the date of this discussion, regardless of the time of delivery of this document. We do not undertake any obligation to update or release any revisions to any forward-looking statements, to report any new information, future event or other circumstances after the date of this filing or to reflect the occurrence of unanticipated events, except as required by law. However, your attention is directed to any further disclosures made on related subjects in any subsequent reports we may file with the FDIC, including on Forms 10-K, 10-Q and 8-K.

***Government and Regulatory Oversight.*** The Bank is subject to regulatory oversight by the Department of Business Oversight (DBO) from the state of California and the Federal Deposit Insurance Corporation (FDIC). These regulatory bodies periodically perform financial examinations of the Bank. There is a potential that an examination may derive different estimates than those reached by management and could require material adjustments or restatements.

***Critical Accounting Policies.*** The discussion and analysis of the Bank's results of operations and financial condition are based upon financial statements which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires the Bank's management to make estimates and judgments that affect the reported amounts of assets and liabilities, income and expense, and the related disclosures of contingent assets and liabilities at the date of these financial statements.

The Bank believes these estimates and assumptions to be reasonably accurate; however, actual results may differ from these estimates under different assumptions or circumstances. Material estimates that are particularly susceptible to significant change in the near-term relate to the determination of the allowance for loan losses, consideration of goodwill impairment, valuation of other real estate owned, and consideration of potential other than temporary impairment on investment securities.

***Allowance for Loan Losses.*** The allowance for loan losses is determined first and foremost by promptly identifying potential credit weaknesses that could jeopardize repayment. The Bank's process for evaluating the adequacy of the allowance for loan losses includes determining estimated loss percentages for each credit based on the Bank's historical loss experience and other factors in the Bank's credit grading system and accompanying risk analysis for determining an adequate level of the allowance. The risks are assessed by rating each account based upon paying habits, loan to collateral value ratio, financial condition and level of classifications. The allowance for loan losses was \$4,664,000 at September 30, 2015 compared to \$5,143,000 at December 31, 2014.

The Bank maintains the allowance for loan losses to provide for probable incurred losses in the loan portfolio. Additions to the allowance for loan losses are established through a provision charged to expense. All loans which are judged to be uncollectible are charged against the allowance while any recoveries are credited to the allowance.

The Bank's policy is to charge off any known losses at the time of determination. Any unsecured loan more than 90 days delinquent in payment of principal or interest and not in the process of collection is charged off in total. Secured loans are evaluated on a case by case basis to determine the ultimate loss potential to us subsequent to the liquidation of collateral. In those cases where we believe we are inadequately protected, a charge-off will generally be made to reduce the loan balance to a level equal to the liquidation value of the collateral unless we believe the collateral deficiency may be overcome by borrower cash flows.

The Bank's loan policy provides procedures designed to evaluate and assess the credit risk factors associated with the loan portfolio, to enable the Bank to assess such credit risk factors prior to granting new loans and to evaluate the sufficiency of the allowance for loan losses. The Bank conducts an assessment of the allowance on a monthly basis and undertakes a more critical evaluation quarterly. At the time of the quarterly review, the Board of Directors will examine and formally approve the adequacy of the allowance. The quarterly evaluation includes an assessment of the following factors: any external loan review and any recent regulatory examination, estimated potential loss exposure on each pool of loans, concentrations of credit, value of collateral, the level of delinquent and nonaccrual loans, trends in loan volume, effects of any changes in lending policies and procedures, changes in lending personnel, current economic conditions at the local, state and national level and historical losses and recoveries.

***Goodwill.*** We assess the carrying value of our goodwill at least annually in order to determine if this intangible asset is impaired. In reviewing the carrying value of our goodwill, we assess the recoverability of such assets by evaluating the fair value of the related business unit. If the carrying amount of goodwill exceeds its fair value, an impairment loss is recognized for the amount of the excess and the carrying value of goodwill is reduced accordingly. Any impairment would be required to be recorded during the period identified.

Accounting standards require an annual evaluation of goodwill for impairment using various estimates and assumptions. The market price of the Bank's common stock at the close of business on September 30, 2015 was \$13.07 per common share compared to a book value of \$11.91 per common share.

***Investment Securities.*** We assess at each reporting date whether there is an "other-than-temporary" impairment to our investment securities. Such impairment, if related to credit losses, must be recognized in current earnings rather than in other comprehensive income or loss, net of tax. We examine all individual securities that are in an unrealized loss position at each reporting date for other-than-temporary impairment (OTTI). Specific investment level factors we examine to assess impairment include, the severity and duration of the unrealized loss, the nature, financial condition and results of operations of the issuers of the securities and whether there has been any cause for default on the securities or any adverse change in the rating of the securities by the various rating agencies, as well as whether the decline in value is credit or liquidity related. Additionally, we reexamine our financial resources and our overall intent and ability to hold the securities until their fair values recover. There were no OTTI recorded in 2015 or 2014. Investment securities are discussed in more detail under "Investment Portfolio."

**Financial Summary**  
(In thousands except per share data)

	Three Months Ended		Nine Months Ended	
	September 30, 2015 (Unaudited)	September 30, 2014 (Unaudited)	September 30, 2015 (Unaudited)	September 30, 2014 (Unaudited)
<b>Statement of Income Data:</b>				
Net interest income	\$ 4,509	\$ 4,330	\$ 13,016	\$ 12,750
Provision for loan losses	-	-	(800)	(400)
Non-interest income	379	540	2,282	1,395
Non-interest expense	2,712	2,855	8,024	8,292
Provision for income taxes	896	832	3,328	2,578
Net income	<u>\$ 1,280</u>	<u>\$ 1,183</u>	<u>\$ 4,746</u>	<u>\$ 3,675</u>
Less: preferred dividends	23	34	92	103
Net income available for common stockholders	<u>\$ 1,257</u>	<u>\$ 1,149</u>	<u>\$ 4,654</u>	<u>\$ 3,572</u>
<b>Selected per Common Share Data:</b>				
Basic earnings per common share	\$ 0.26	\$ 0.24	\$ 0.97	\$ 0.75
Diluted earnings per common share	\$ 0.26	\$ 0.24	\$ 0.96	\$ 0.74
Dividend per share	\$ 0.12	\$ 0.11	\$ 0.36	\$ 0.33
Book value per common share (2)(3)	\$ 11.91	\$ 10.90	\$ 11.91	\$ 10.90
<b>Selected Balance Sheet Data:</b>				
Assets	\$ 505,564	\$ 463,376	\$ 505,564	\$ 463,376
Loans, net	330,325	285,809	330,325	285,809
Deposits	393,606	364,896	393,606	364,896
Average assets	494,934	466,107	478,915	460,523
Average earning assets	484,515	451,062	467,636	445,373
Average shareholders' equity	65,559	65,711	67,666	64,223
Average common shareholders' equity	56,498	52,044	55,552	50,557
Nonperforming loans	1,395	3,334	1,395	3,334
Other real estate owned	-	4,051	-	4,051
Total nonperforming assets	1,395	7,385	1,395	7,385
Troubled debt restructures (accruing)	3,585	4,960	3,585	4,960
<b>Selected Ratios:</b>				
Return on average assets (1)	1.03%	1.01%	1.32%	1.07%
Return on average common equity (1)	8.83%	8.76%	11.20%	9.45%
Efficiency ratio (4)	56.11%	59.36%	52.82%	58.93%
Net interest margin (1)	3.69%	3.81%	3.72%	3.83%
Common equity tier 1 capital ratio (5)	13.7%	-	13.7%	-
Tier 1 capital ratio	13.7%	17.7%	13.7%	17.7%
Total capital ratio	14.9%	19.0%	14.9%	19.0%
Tier 1 leverage ratio	10.6%	13.3%	10.6%	13.3%
Common dividend payout ratio (6)	45.51%	45.78%	36.96%	44.15%
Average equity to average assets	13.25%	14.10%	14.13%	13.95%
Nonperforming loans to total loans (2)	0.42%	1.15%	0.42%	1.15%
Nonperforming assets to total assets (2)	0.28%	1.59%	0.28%	1.59%
Allowance for loan losses to total loans (2)	1.39%	1.71%	1.39%	1.71%
Allowance for loan losses to nonperforming loans (2)	334.20%	149.17%	334.20%	149.17%

(1) Annualized

(2) As of period end

(3) Total shareholders' equity, less preferred stock, divided by total common shares outstanding

(4) Non-interest expenses to net interest and non-interest income, net of securities gains.

(5) Common equity tier 1 capital ratio requirement was effective January 1, 2015.

(6) Common dividends divided by net income available for common stockholders

## Results of Operations

### *Three and nine months ended September 30, 2015 and September 30, 2014*

The Bank's primary source of income is net interest income, which is the difference between interest income and fees derived from earning assets and interest paid on liabilities which fund those assets. Net interest income, expressed as a percentage of total average interest earning assets, is referred to as the net interest margin. The Bank's net interest income is affected by changes in the volume and mix of interest earning assets and interest bearing liabilities. It is also affected by changes in yields earned on interest earning assets and rates paid on interest bearing deposits and other borrowed funds. The Bank also generates non-interest income, including transactional fees, service charges, office lease income, gains and losses on investment securities and gains on sold SBA guaranteed loans originated by the Bank. Non-interest expenses consist primarily of employee compensation and benefits, occupancy and equipment expenses and other operating expenses. The Bank's results of operations are also affected by its provision for loan losses. Results of operations may also be significantly affected by other factors including general economic and competitive conditions, mergers and acquisitions of other financial institutions within the Bank's market area, changes in market interest rates, government policies, and actions of regulatory agencies.

### Net Income

The Bank reports "net income" which reflects the results of its operations for the periods and "net income available for common stockholders" which is net income less preferred stock dividends declared during the periods.

For the three months ended September 30, 2015, net income was \$1,280,000, and net income available for common stockholders was \$1,257,000 compared to net income of \$1,183,000 and net income available for common stockholders of \$1,149,000 for the three months ended September 30, 2014. Earnings per diluted common share were \$0.26 for the three months ended September 30, 2015 compared to \$0.24 for the three months ended September 30, 2014. Annualized return on average assets was 1.03% for the third quarter of 2015 compared to 1.01% for the third quarter of 2014.

Net income for the nine months ended September 30, 2015 and 2014 was \$4,746,000 and \$3,675,000. Net income available for common stockholders was \$4,654,000 and \$3,572,000 for the nine month periods of 2015 and 2014. Earnings per diluted common share were \$0.96 and \$0.74 for the nine months ended September 30, 2015 and 2014. Annualized return on average assets was 1.32% and 1.07% for the nine month periods of 2015 and 2014.

### Net Interest Income and Net Interest Margin

Net interest income increased \$179,000 or 4.1% to \$4,509,000 for the third quarter of 2015 compared to \$4,330,000 for the same quarter of 2014. The annualized net interest margin declined to 3.69% for the third quarter of 2015, compared to 3.81% for the third quarter of 2014.

Average earning assets increased 7.4% to \$484,515,000 for the third quarter of 2015, as compared to \$451,062,000 for the same quarter of 2014. The annualized yield on average earning assets was 3.89% and the annualized cost of average interest-bearing liabilities was 0.28% for the third quarter of 2015, as compared to the annualized yield on average earning assets of 4.04% and annualized cost of interest-bearing liabilities of 0.31% for the same quarter of 2014.

Net interest income and the net interest margin for the nine months ended September 30, 2015 was \$13,016,000 and 3.72% compared to \$12,750,000 and 3.83% for the nine months ended September 30, 2014. The increase in net interest income was due to the increase in earning assets between periods, which offset the impacts of the declining net interest margin.

The net interest margin declined as a result of impacts from the levels of investment securities that are called or matured and are replaced at lower yields and lower yields on loans from the general decline in interest rates. These effects were partially offset with the decline in deposit and borrowing interest costs.

The following table presents condensed average balance sheet information for the Bank, together with interest rates earned and paid on the various sources and uses of its funds for each of the periods presented. Average balances are based on daily average balances. Nonaccrual loans are included in loans with any interest collected reflected on a cash basis.

	Three Months Ended September 30, 2015			Three Months Ended September 30, 2014		
	Average Balance	Interest Income/ Expense	Average Rate (4)	Average Balance	Interest Income/ Expense	Average Rate (4)
(Dollars in thousands)						
<b>Assets</b>						
Interest earning assets:						
Interest-bearing deposits in banks	\$ 18,972	\$ 10	0.20%	\$ 19,709	\$ 10	0.21%
Federal funds sold	1,967	1	0.17%	1,929	1	0.14%
Time deposits with banks	744	3	1.57%	1,240	5	1.51%
Taxable investment securities	135,174	971	2.85%	136,092	960	2.80%
Loans, net of unearned income (1)	327,658	3,766	4.56%	292,092	3,612	4.91%
Total earning assets/interest income	484,515	4,751	3.89%	451,062	4,588	4.04%
Non-earning assets	14,977			20,017		
Allowance for loan losses	(4,558)			(4,972)		
Total assets	\$ 494,934			\$ 466,107		
<b>Liabilities and Shareholders' Equity</b>						
Interest-bearing liabilities:						
Deposits:						
Interest-bearing demand deposits	\$ 50,392	12	0.09%	\$ 53,538	9	0.07%
Savings and money market	91,259	33	0.14%	82,237	36	0.17%
Time deposits	144,446	147	0.40%	158,714	170	0.42%
FHLB advances	55,268	50	0.36%	35,777	43	0.47%
Total interest-bearing liabilities/interest expense	341,365	242	0.28%	330,266	258	0.31%
Non interest-bearing deposits	86,373			68,828		
Other liabilities	1,637			1,302		
Total liabilities	429,375			400,396		
Shareholders' equity	65,559			65,711		
Total liabilities and shareholders' equity	\$ 494,934			\$ 466,107		
Net interest income and margin (2)		\$ 4,509	3.69%	\$ 4,330		3.81%
Net interest spread (3)			3.61%			3.73%

- (1) The net amortization of deferred fees and costs on loans included in interest income was \$(33,000) and \$25,000 for the three months ended September 30, 2015 and 2014, respectively.
- (2) Net interest margin is computed by dividing net interest income by average total earning assets.
- (3) Net interest spread is the difference between the average rate earned on average total earning assets and the average rate paid on average total interest bearing liabilities.
- (4) Annualized.

	Nine Months Ended September 30, 2015			Nine Months Ended September 30, 2014		
	Average Balance	Interest Income/ Expense	Average Rate (4)	Average Balance	Interest Income/ Expense	Average Rate (4)
(Dollars in thousands)						
<b>Assets</b>						
Interest earning assets:						
Interest-bearing deposits in banks	\$ 18,864	\$ 30	0.22%	\$ 17,858	\$ 29	0.21%
Federal funds sold	1,938	2	0.16%	1,770	2	0.14%
Time deposits with banks	1,058	11	1.43%	1,722	16	1.26%
Taxable investment securities	139,216	3,042	2.92%	133,503	2,868	2.87%
Loans, net of unearned income (1)	306,560	10,615	4.63%	290,520	10,614	4.88%
Total earning assets/interest income	<u>467,636</u>	<u>13,700</u>	3.92%	<u>445,373</u>	<u>13,529</u>	4.06%
Non-earning assets	16,269			20,410		
Allowance for loan losses	(4,990)			(5,260)		
Total assets	<u>\$ 478,915</u>			<u>\$ 460,523</u>		
<b>Liabilities and Shareholders' Equity</b>						
Interest-bearing liabilities:						
Deposits:						
Interest-bearing demand deposits	\$ 54,606	43	0.10%	\$ 51,876	24	0.06%
Savings and money market	89,103	104	0.16%	81,999	111	0.18%
Time deposits	139,661	398	0.38%	158,209	520	0.44%
FHLB advances	47,044	139	0.40%	38,046	124	0.44%
Total interest-bearing liabilities/interest expense	<u>330,414</u>	<u>684</u>	0.28%	<u>330,130</u>	<u>779</u>	0.32%
Non interest-bearing deposits	79,498			64,942		
Other liabilities	1,337			1,228		
Total liabilities	<u>411,249</u>			<u>396,300</u>		
Shareholders' equity	67,666			64,223		
Total liabilities and shareholders' equity	<u>\$ 478,915</u>			<u>\$ 460,523</u>		
Net interest income and margin (2)		<u>\$ 13,016</u>	3.72%		<u>\$ 12,750</u>	3.83%
Net interest spread (3)			3.64%			3.74%

- (1) The net amortization of deferred fees and costs on loans included in interest income was \$(121,000) and \$116,000 for the nine months ended September 30, 2015 and 2014, respectively.
- (2) Net interest margin is computed by dividing net interest income by average total earning assets.
- (3) Net interest spread is the difference between the average rate earned on average total earning assets and the average rate paid on average total interest bearing liabilities.
- (4) Annualized.



The following table shows the change in interest income and interest expense and the amount of change attributable to variances in volume and rates. The unallocated change in rate or volume variance has been allocated between the rate and volume variances in proportion to the absolute dollar amount of the change of each.

Volume and Yield/Rate Variances			
2015 Compared to 2014 for the Three Months Ended			
September 30			
Change Due to			
(Dollars in thousands)	Net	Volume	Yield/Rate
<b>Interest income:</b>			
Interest-bearing deposits in banks	\$ -	\$ -	\$ -
Federal funds sold	-	-	-
Time deposits with banks	(2)	(2)	-
Taxable investment securities	11	(6)	17
Loans, net of unearned income	154	420	(266)
Total interest income	<u>163</u>	<u>412</u>	<u>(249)</u>
<b>Interest expense:</b>			
Interest-bearing demand deposits	\$ 3	(1)	4
Savings and money market	(3)	4	(7)
Time deposits	(23)	(16)	(7)
FHLB advances	7	19	(12)
Total interest expense	<u>(16)</u>	<u>6</u>	<u>(22)</u>
Increase (decrease) in net interest income	<u>\$ 179</u>	<u>\$ 406</u>	<u>\$ (227)</u>

Volume and Yield/Rate Variances			
2015 Compared to 2014 for the Nine Months Ended			
September 30			
Change Due to			
(Dollars in thousands)	Net	Volume	Yield/Rate
<b>Interest income:</b>			
Interest bearing deposits in banks	\$ 1	\$ 2	\$ (1)
Federal funds sold	-	-	-
Time deposits with banks	(5)	(6)	1
Taxable investment securities	174	124	50
Loans, net of unearned income	1	570	(569)
Total interest income	<u>171</u>	<u>690</u>	<u>(519)</u>
<b>Interest expense:</b>			
Interest-bearing demand deposits	\$ 19	1	18
Savings and money market	(7)	9	(16)
Time deposits	(122)	(65)	(57)
FHLB advances	15	27	(12)
Total interest expense	<u>(95)</u>	<u>(28)</u>	<u>(67)</u>
Increase (decrease) in net interest income	<u>\$ 266</u>	<u>\$ 718</u>	<u>\$ (452)</u>

## Provision for Loan Losses

The Bank maintains an allowance for loan losses for probable incurred losses that are expected as an incidental part of the banking business. Write-offs of loans are charged against the allowance for loan losses, which is adjusted periodically to reflect changes in the volume of outstanding loans and estimated losses due to changes in the financial condition of borrowers or the value of property securing nonperforming loans, or changes in general economic conditions and other qualitative factors. Additions to the allowance for loan losses are made through a charge against income referred to as the “provision for loan losses”.

The Bank’s loan policy provides procedures designed to evaluate and assess the credit risk factors associated with the loan portfolio, to enable management to assess such credit risk factors prior to granting new loans and to evaluate the sufficiency of the allowance for loan losses. Management conducts an assessment of the allowance for loan losses on a monthly basis and undertakes a more critical evaluation quarterly. At the time of the quarterly review, the Board of Directors evaluates and formally approves the adequacy of the allowance. The quarterly evaluation includes an assessment of the following factors: any external loan review and regulatory examination, estimated probable loss exposure on each pool of loans, concentrations of credit, value of collateral, the level of delinquent and nonaccrual loans, trends in loan volume, effects of any changes in the lending policies and procedures, changes in lending personnel, current economic conditions at the local, state and national level, and a migration analysis of historical losses and recoveries for the prior twelve quarters.

There was \$800,000 of provision reversal for the nine months ended September 30, 2015 and no provision in the third quarter of 2015. This compares to \$400,000 of provision reversal for the nine months ended September 30, 2014 and no provision in the third quarter of 2014. The provision reversals reflect changes in specific allowance allocations for impaired loans, improvements in the general real estate economy and adjustments in various qualitative factors related to measurement of the adequacy of the allowance for loan losses. The Bank has experienced continued improvement in credit quality through a reduction in the amount of problem loans. The nonperforming loans to total loans ratio declined to 0.42% at September 30, 2015 compared to 1.15% at September 30, 2014. During the nine months ended September 30, 2015, there were \$2,000 in loan charge-offs compared to \$81,000 in loan charge-offs for the nine months ended September 30, 2014. There were \$323,000 in loan recoveries during the nine months ended September 30, 2015, compared to \$42,000 for the same period in 2014. Specific allowance allocations for impaired loans totaled \$691,000 at September 30, 2015 and \$1,495,000 at December 31, 2014 and \$1,527,000 at September 30, 2014. The change in specific allowance allocations was primarily due to the reduction in nonperforming loans between the periods. See Balance Sheet Activity – Nonperforming Assets and Allowance for Loan Losses for additional discussion.

Future provisions for loan losses are dependent on asset quality trends, loan portfolio growth and the general condition of the economy. As a significant portion of the Bank’s loan portfolio is collateralized by real estate, the valuation of the underlying collateral can have a significant impact on the adequacy of the allowance for loan losses and specific allocations for impaired loans, which may require future loan loss provisions.

## Non-interest Income

The following are the sources of non-interest income for the periods indicated:

(in thousands)	Three Months Ended			Nine Months Ended		
	September 30, 2015	September 30, 2014	Change	September 30, 2015	September 30, 2014	Change
Service charges on deposit accounts	\$ 188	\$ 159	\$ 29	\$ 525	\$ 445	\$ 80
Rental income	133	130	3	399	392	7
Net securities gains	55	60	(5)	108	73	35
Net gain on other real estate owned	-	-	-	1,125	73	1,052
Loan servicing, net	2	3	(1)	6	9	(3)
Other income	1	188	(187)	119	403	(284)
Total non-interest income	<u>\$ 379</u>	<u>\$ 540</u>	<u>\$ (161)</u>	<u>\$ 2,282</u>	<u>\$ 1,395</u>	<u>\$ 887</u>

Service charges on deposit accounts increased in the 2015 periods primarily due to increased number of demand deposit accounts. The gain on other real estate owned resulted from the sale of one property during the first quarters 2015 and 2014. Other income includes rental income on other real estate owned which was \$0 and \$113,000 for the three months ended September 30, 2015 and 2014, and \$118,000 and \$320,000 for the nine month periods in 2015 and 2014. The Bank currently does not have any remaining other real estate owned.

## Non-interest Expense

The following are the sources of non-interest expense for the periods indicated:

(in thousands)	Three Months Ended			Nine Months Ended		
	September 30, 2015	September 30, 2014	Change	September 30, 2015	September 30, 2014	Change
Salaries and employee benefits	\$ 1,499	\$ 1,412	\$ 87	\$ 4,217	\$ 4,152	\$ 65
Occupancy and equipment	327	383	(56)	976	996	(20)
Other expenses	886	1,060	(174)	2,831	3,144	(313)
Total non-interest expense	<u>\$ 2,712</u>	<u>\$ 2,855</u>	<u>\$ (143)</u>	<u>\$ 8,024</u>	<u>\$ 8,292</u>	<u>\$ (268)</u>

Salaries and employee benefits expense increased for the 2015 periods primarily due to increased employees, partially offset by increased loan originations and the deferred salary expense recorded attributable to the originations. Deferred loan origination expenses in 2015 were \$232,000 and \$750,000 for the three and nine month periods compared to \$150,000 and \$515,000 for the same periods in 2014. The amount of expenses deferred is dependent on the number and types of loans originated during a period.

The decline in other expenses was partially attributable to the sale of other real estate owned and the elimination of the corresponding operating costs of the properties. Other real estate owned operating expenses were \$0 and \$67,000 for the three and nine month periods in 2015, compared to \$54,000 and \$153,000 for the same periods in 2014.

## Provision for Income Taxes

The Bank accrues income tax expense based on the anticipated annual tax rates during the financial period covered. The provision for income taxes and effective combined Federal and State corporate income tax rates for the three and nine months ended September 30, 2015 were \$896,000 (41.2%) and \$3,328,000 (41.2%) compared to \$832,000 (41.2%) and \$2,578,000 (41.2%) for the same periods ended September 30, 2014.

## Balance Sheet Activity

### At September 30, 2015 and December 31, 2014

## Investment Portfolio

Securities classified as available-for-sale for accounting purposes are recorded at their fair value on the balance sheet. Available-for-sale (AFS) investment securities carried at fair value totaled \$125,681,000 at September 30, 2015 and comprised 25% of total assets compared to amortized cost of \$124,161,000. At September 30, 2015, the Bank had investment securities classified as held-to-maturity, carried at cost of \$5,987,000 with a fair market value of \$5,858,000 and represented 1.2% of total assets. At December 31, 2014, investment securities comprised 29% of total assets with AFS investments at a fair value of \$124,723,000 and amortized cost of \$123,503,000. Held-to-maturity investments at December 31, 2014 were carried at amortized cost of \$9,977,000 and had a fair market value of \$9,776,000. Changes in the fair value of AFS securities (e.g., unrealized holding gains or losses) are reported as "other comprehensive income (loss)," net of tax, and carried as accumulated other comprehensive income or loss, net of tax, within shareholders' equity until realized, unless any declines in value below amortized cost are the result of other than temporary impairment. The held-to-maturity investments are government agency callable securities with step-up interest rates.

During the first nine months of 2015, bonds were purchased with an initial cost of \$11,985,000, bonds were sold with an amortized cost of \$3,489,000 and bonds were called with an amortized cost of \$11,498,000. The net gain on the sold and called bonds was \$108,000.

The Bank utilizes the investment portfolio to manage liquidity and attract funding that requires collateralization. At September 30, 2015, investment securities with fair value of \$61,378,000 were pledged to secure time deposits from the State of California or pledged for the Federal Discount Window and represented 47% of the investment portfolio. At December 31, 2014, investment securities with fair value of \$51,948,000, or 39% of the investment portfolio, were pledged. At September 30, 2015 investment securities with a fair value of \$71,491,000 were callable within one year.

The Bank does not own securities of any single issuer (other than U.S. Government agencies and corporations) whose aggregate book value was in excess of 10% of the Bank's total shareholders' equity at the time of purchase.

## Loan Portfolio

The following table shows the composition of the loan portfolio by amount, percentage of total loans for each major loan category and the dollar volume and percentage change between the dates indicated.

(in thousands)	September 30, 2015	%	December 31, 2014	%	Net Change	Percent Change
Commercial & agricultural (1)	\$ 79,517	23.7%	\$ 68,371	23.9%	\$ 11,146	16.3%
Real estate - commercial	159,203	47.5%	145,565	51.2%	13,638	9.4%
Real estate - construction and land	10,579	3.2%	11,175	3.9%	(596)	(5.3)%
Real estate - single family	65,625	19.6%	46,590	16.3%	19,035	40.9%
Real estate - multifamily	19,519	5.8%	13,095	4.6%	6,424	49.1%
Consumer & lease financing	546	0.2%	145	0.1%	401	276.6%
	<u>334,989</u>	<u>100%</u>	<u>284,941</u>	<u>100%</u>	<u>50,048</u>	<u>17.6%</u>
<b>LESS:</b>						
Allowance for Loan Losses	(4,664)		(5,143)		479	(9.3)%
Total Loans, Net	<u>\$ 330,325</u>		<u>\$ 279,798</u>		<u>\$ 50,527</u>	<u>18.1%</u>

(1) Includes loans secured by farmland.

The Bank has experienced an increase in loan applications which resulted in the increased loan balances shown above. Additionally the Bank purchased whole loan portfolios of single family residential mortgage loans in the amounts of \$8,597,000 in the second quarter and \$12,071,000 in the first quarter of 2015. These mortgage loans are adjustable at 5 or 7 years from origination date.

At September 30, 2015, the Bank had approximately \$37,836,000 in undisbursed loan commitments, of which approximately \$11,830,000 related to real estate loan types. At December 31, 2014, the Bank had approximately \$26,374,000 in undisbursed loan commitments, of which approximately \$12,235,000 related to real estate loan types.

## Nonperforming Assets

Nonperforming assets consist of nonperforming loans and other real estate owned. Nonperforming loans are those for which the borrower fails to perform under the terms of the obligation and consist of nonaccrual loans, accruing loans past due 90 days or more and restructured loans, if applicable.

The following are the nonperforming assets for the respective periods:

(in thousands)	September 30, 2015	December 31, 2014
Nonaccrual loans	\$ 1,395	\$ 1,815
Accruing loans past due 90 days or more	-	-
Total nonperforming loans	1,395	1,815
Other real estate owned	-	4,051
Total nonperforming assets	<u>\$ 1,395</u>	<u>\$ 5,866</u>
Nonperforming loans to total loans	0.42%	0.64%
Nonperforming assets to total assets	0.28%	1.28%
Allowance for loan losses to nonperforming loans	334.20%	283.39%

Nonperforming loans at September 30, 2015 are primarily secured by real property. There were \$3,916,000 and \$6,209,000 in loans classified as troubled debt restructurings (TDR) at September 30, 2015 and December 31, 2014. The total of TDRs includes \$330,000 and \$654,000 at September 30, 2015 and December 31, 2014, that are included in the nonperforming loans above.

There was no other real estate owned (OREO) at September 30, 2015.

### **Allowance for Loan Losses**

The Bank maintains the allowance for loan losses to provide for inherent losses in the loan portfolio. Additions to the allowance for loan losses are established through a provision for loan losses charged to expense. All loans which are judged to be uncollectible are charged against the allowance while any recoveries are credited to the allowance. The Bank's policy is to charge off any known losses at the time of determination. Any unsecured loan more than 90 days delinquent in payment of principal or interest and not in the process of collection is charged off in total. Secured loans are evaluated on a case by case basis to determine the ultimate loss potential to us subsequent to the liquidation of collateral. In those cases where we believe we are inadequately protected, a charge off will be made to reduce the loan balance to a level equal to the liquidation value of the collateral.

The Bank's loan policy provides procedures designed to evaluate and assess the credit risk factors associated with the loan portfolio, to enable management to assess such credit risk factors prior to granting new loans and to evaluate the sufficiency of the allowance for loan losses. Management conducts an assessment of the allowance for loan losses on a monthly basis and undertakes a more critical evaluation quarterly. At the time of the quarterly review, the Board of Directors evaluates and formally approves the adequacy of the allowance. The quarterly evaluation includes an assessment of the following factors: any external loan review and regulatory examination, estimated probable incurred loss exposure on each pool of loans, concentrations of credit, value of collateral, the level of delinquent and nonaccrual loans, trends in loan volume, effects of any changes in lending policies and procedures, changes in lending personnel, current economic conditions at the local, state and national level and a migration analysis of historical losses and recoveries for the prior twelve quarters.

In addition to the allowance for loan losses, the Bank maintains an allowance for losses for undisbursed loan commitments which is reported in other liabilities on the consolidated balance sheets. This allowance was \$30,000 as of September 30, 2015 and December 31, 2014.

The following table summarizes the activity in the Allowance for Loan Losses during the periods indicated.

SUMMARY OF ACTIVITY IN ALLOWANCE FOR LOAN LOSSES  
(Dollars in thousands)

(Dollars in thousands)	Nine Months Ended September 30, 2015	Year Ended December 31, 2014
	<u>2015</u>	<u>2014</u>
Balance at beginning of period	\$ 5,143	\$ 5,412
Charge-offs:		
Commercial & agricultural	-	-
Real estate - commercial	-	76
Real estate - construction and land	-	-
Real estate - single family	-	-
Real estate - multifamily	-	-
Consumer & lease financing	2	5
Total loans charged-off	<u>2</u>	<u>81</u>
Recoveries:		
Commercial & agricultural	161	207
Real estate - commercial	-	977
Real estate - construction and land	-	-
Real estate - single family	133	15
Real estate - multifamily	-	-
Consumer & lease financing	29	13
Total recoveries	<u>323</u>	<u>1,212</u>
Net loans charged-off	(321)	(1,131)
Provision for loan losses	(800)	(1,400)
Allowance for loan losses - end of period	<u>\$ 4,664</u>	<u>\$ 5,143</u>
Loans:		
Average loans outstanding during period, net of unearned income	\$ 327,658	\$ 289,948
Total loans at end of period, net of unearned income	\$ 334,989	\$ 284,941
Ratios:		
Net loans charged-off to average net loans (1)	(0.13)%	(0.39)%
Net loans charged-off to total loans (1)	(0.13)%	(0.40)%
Allowance for loan losses to average net loans	1.42%	1.77%
Allowance for loan losses to total loans	1.39%	1.80%
Net loans charged-off to beginning allowance for loan losses (1)	(8.34)%	(20.90)%
Net loans charged-off to provision for loan losses	40.13%	80.79%

(1) Annualized

## Allocation of Allowance for Loan Losses

(in thousands)	September 30, 2015		December 31, 2014	
	Allowance Allocation	Amount of Category Loans to Total Loans	Allowance Allocation	Amount of Category Loans to Total Loans
Commercial & agricultural	\$ 988	23.7%	\$ 534	23.9%
Real estate - commercial	1,096	47.5%	1,861	51.2%
Real estate - construction and land	53	3.2%	216	3.9%
Real estate - single family	380	19.6%	141	16.3%
Real estate - multifamily	39	5.8%	13	4.6%
Consumer & lease financing	6	0.2%	10	0.1%
Unallocated	2,102		2,368	
Total	\$ 4,664	100%	\$ 5,143	100%

The allowance allocation to real estate loan categories is highly dependent on the estimated real estate collateral values that secure specific troubled loans. The specific loans being evaluated at one period versus another can result in variations in the allocations. The decline in allowance allocation for the commercial real estate category between December 31, 2014 and September 30, 2015 was attributable to the general improvement of commercial real estate values and the decline in nonperforming commercial real estate collateralized loans. The increase in allowance allocated to commercial and agricultural loans was primarily attributable to the increase in amount of these types of loans.

Part of the allocation of the allowance for loan losses is based on other qualitative factors and is attributable to management's assessment of various qualitative factors. Qualitative factors included the size of individual credits, concentrations and general economic conditions. Management also considers these qualitative factors in their evaluation of the adequacy of the allowance for loan losses. An unallocated allowance can arise from fluctuations in the amount of classified and nonperforming loans ("changes in credit grades") between periods. The Internal Asset Review Committee reviews the amount and reasons for unallocated allowances and whether it has arisen due to periodic fluctuations in the credit grades or has arisen due to changes in qualitative factors or changes in lending strategies. If the unallocated allowance has arisen from other than periodic fluctuations in credit grades, then the Internal Asset Review Committee may determine that a portion of the allowance for loan losses should be reversed. Factors used in determining whether the unallocated allowance should be maintained includes the trend in impaired and classified loans, the projected increase in new loans and additional allowance that may be attributed to recoveries of previously charged-off loans.

### Deposits

At September 30, 2015, the Bank had a deposit mix of 41% in time deposits, 24% in money market and savings accounts, and 35% in demand accounts. At December 31, 2014, the Bank had a deposit mix of 40% in time deposits, 24% in money market and savings accounts, and 36% in demand accounts.

At September 30, 2015 and December 31, 2014, the State of California had \$48,500,000 in time deposits with the Bank with maturities of up to 6 months and collateralized by investment securities and mortgage loans. These deposits are received through a program run by the Treasurer of the State of California to place public deposits with community banks.

At September 30, 2015, the Bank had \$68,203,000 in brokered deposits. This compares to \$64,370,000 in brokered deposits at December 31, 2014. The brokered deposits included \$35,205,000 and \$21,461,000 in wholesale brokered deposits at September 30, 2015 and December 31, 2014. The remaining brokered deposits of \$32,998,000 at September 30, 2015 and \$42,919,000 at December 31, 2014, were raised locally from the Bank's customers through a reciprocal deposit placement service called CDARS and ICS, which are classified as brokered deposits for FFIEC Call Report purposes.

The Bank obtains time deposits through an internet listing service. These deposits are primarily from other financial institutions. There were \$22,491,000 and \$14,863,000 of internet obtained deposits at September 30, 2015 and December 31, 2014.

## Liquidity and Capital Resources

Maintenance of adequate liquidity requires that sufficient resources be available at all times to meet cash flow requirements of the Bank. Liquidity in a banking institution is required primarily to provide for deposit withdrawals and the credit needs of customers and to take advantage of investment opportunities as they arise. A bank may achieve desired liquidity from both assets and liabilities. Cash and deposits held in other banks, Federal funds sold, other short term investments, maturing loans and investments, payments of principal and interest on loans and investments, and potential loan and investment securities sales are sources of asset liquidity. Deposit growth and access to credit lines established with correspondent banks, primarily with the FHLB, Federal Reserve and access to brokered certificates of deposit are sources of liability liquidity. The Bank reviews its liquidity position on a regular basis based upon its current position and expected trends of loans and deposits. Management believes that the Bank maintains adequate sources of liquidity to meet its liquidity needs.

The Bank's liquid assets, defined as cash and cash equivalents, deposits with banks, Federal funds sold and the market value of unpledged available-for-sale investment securities, totaled \$97,320,000 and constituted 19% of total assets at September 30, 2015 compared to \$100,183,000 or 22% of total assets at December 31, 2014.

Although the Bank's sources of liquidity include liquid assets, the Bank maintains lines of credit with the Federal Home Loan Bank and other correspondent banks. The total of unused lines of credit were \$77 million at September 30, 2015 and \$92 million at December 31, 2014. The Bank actively utilizes its borrowing capacity with the Federal Home Loan Bank to manage liquidity as well as to provide a funding alternative to time deposits, if the Federal Home Loan Bank's interest rates and terms are more favorable. The advances from the Federal Home Loan Bank can have maturities from overnight to multiple years. The line of credit with the FHLB is based on eligible loans that are pledged for the borrowings.

The Bank is able to borrow from the Federal Reserve Discount Window by pledging investment securities or loans. The amount that is available is dependent on the value of the assets pledged.

As presented in the accompanying unaudited consolidated statements of cash flows, the sources of liquidity vary between periods. Our cash and cash equivalents at September 30, 2015 totaled \$26,286,000, an increase of \$2,973,000 over December 31, 2014. The primary uses of funds during the first nine months of 2015 were \$11,985,000 in investment security purchases, \$49,606,000 increase in loans and \$13,750,000 retirement of preferred stock. The primary sources of funds during the first nine months of 2015 included \$14,987,000 from maturities, calls and sales of investment securities, \$38,347,000 from an increase in deposits and \$17,000,000 increase in FHLB advances.

On January 1, 2015, the FDIC instituted new capital requirements known as BASEL III capital requirements. The new requirements established new required ratio amounts and a new capital ratio called the common equity tier 1 capital ratio. The following table presents the capital ratios for Summit State Bank and the correspondent regulatory minimum requirements:

(in thousands)	September 30, 2015	
	Amount	Ratio
<u>Common Equity Tier 1 Capital Ratio</u>		
Summit State Bank	\$ 51,989	13.7%
Minimum requirement for "Well-Capitalized" institution	\$ 24,728	6.5%
Minimum regulatory requirement	\$ 17,120	4.5%
<u>Tier 1 Capital Ratio</u>		
Summit State Bank	\$ 51,989	13.7%
Minimum requirement for "Well-Capitalized" institution	\$ 30,435	8.0%
Minimum regulatory requirement	\$ 22,826	6.0%
<u>Total Capital Ratio</u>		
Summit State Bank	\$ 56,683	14.9%
Minimum requirement for "Well-Capitalized" institution	\$ 38,044	10.0%
Minimum regulatory requirement	\$ 30,435	8.0%
<u>Tier 1 Leverage Ratio</u>		
Summit State Bank	\$ 51,989	10.6%
Minimum requirement for "Well-Capitalized" institution	\$ 24,541	5.0%
Minimum regulatory requirement	\$ 19,633	4.0%



On August 4, 2011, as part of the Small Business Lending Fund (“SBLF”), the Bank entered into a Small Business Lending Fund Securities Purchase Agreement (“SBLF Purchase Agreement”) with the United States Department of the Treasury (“Treasury”). Under the SBLF Purchase Agreement, the Bank received \$13,750,000 and issued 13,750 shares of preferred stock Series B to the Treasury. The preferred stock was recorded net of \$84,000 in issuance costs. The preferred stock was redeemed on August 31, 2015.

### **Impact of Inflation**

The primary impact of inflation on the Bank is its effect on interest rates. The Bank’s primary source of income is net interest income, which is affected by changes in interest rates. The Bank attempts to limit the impact of inflation on its net interest margin through management of rate-sensitive assets and liabilities and analyses of interest rate sensitivity. The effect of inflation on premises and equipment as well as on non-interest expenses has not been significant for the periods presented.

### **Item 3 Quantitative and Qualitative Disclosures about Market Risk**

Proper management of the rate sensitivity and maturities of assets and liabilities is required to provide an optimum and stable net interest margin. Interest rate sensitivity spread management is an important tool for achieving this objective and for developing ways in which to improve profitability. Management has assessed its market risk at September 30, 2015, and believes that there has been no material change since December 31, 2014.

The Bank constantly monitors earning asset and deposit levels, developments and trends in interest rates, liquidity, capital adequacy and marketplace opportunities. Management responds to all of these to protect and possibly enhance net interest income while managing risks within acceptable levels as set forth in the Bank’s policies. In addition, alternative business plans and transactions are contemplated for their potential impact. This process is known as asset/liability management and is carried out by changing the maturities and relative proportions of the various types of loans, investments, deposits and borrowings in the ways described above. The Board monitors and establishes target positions for interest rate and market value risks through the Asset Liability Committee of the Board.

The tool most commonly used to manage and analyze the interest rate sensitivity of a bank is known as a computer simulation model. To quantify the extent of risks in both the Bank’s current position and in transactions it might make in the future, the Bank uses a model to simulate the impact of different interest rate scenarios on net interest income. The hypothetical impact of an interest rate shock for incremental interest rate changes up to 4.00% is modeled quarterly, representing the primary means the Bank uses for interest rate risk management decisions. The Bank is liability sensitive; that is, more liabilities reprice within one year than assets. The expectation for a liability sensitive bank is that the net interest margin will decline in a rising interest rate environment.

When preparing its modeling, the Bank makes significant assumptions about the lag in the rate of change in various asset and liability categories. The Bank bases its assumptions on past experience and comparisons with other banks, and tests the validity of its assumptions by reviewing actual results with projected expectations.

The computer simulation model projects at September 30, 2015 that the decline over a one year period in net interest income for a 4% shock increase in interest rates is \$2,763,000 or 15.3%. The computer simulation model assumes a static balance sheet, that is, cash flows from various assets and liabilities are reinvested in similar assets and liabilities. It does not model various dynamic changes in the pricing or term of new assets and liabilities that may occur during the year after the interest rate shock.

The Bank’s investment portfolio has an average maturity of 7.2 years, and would be susceptible to a material decline in market value if interest rates were to materially rise. Management monitors this exposure in relation to the Bank’s capital ratios and the interaction of the projected changes in other interest sensitive assets and liabilities to reach a desired balance between current earnings and market risk.

### **Item 4 Controls and Procedures**

Under the supervision and with the participation of the Bank’s management, including its Chief Executive Officer and Chief Financial Officer, the Bank conducted an evaluation of the effectiveness of the design and operation of its disclosure controls and procedures as defined by Rule 13a-15(e) under the Securities Exchange Act of 1934.

Based on the evaluation, the Chief Executive Officer and Chief Financial Officer concluded that as of the end of the period covered by this report the disclosure controls and procedures were adequate and effective, and that the material information required to be included in this report, including information from the Bank's consolidated subsidiary, was properly recorded, processed, summarized and reported, and was made known to the Chief Executive Officer and Chief Financial Officer by others within the Bank in a timely manner, particularly during the period when this quarterly report on Form 10-Q was being prepared.

There was no change in the Bank's internal control over financial reporting that occurred during the most recent fiscal quarter that materially affected, or is reasonably likely to materially affect, internal control over financial reporting.

## **PART II OTHER INFORMATION**

### **Item 1 Legal Proceedings**

The nature of our business causes us to be involved in legal proceedings from time to time. As of the date of this report, the Bank is not a party to any litigation where management anticipates that the outcome will have a material adverse effect on the consolidated financial position or results of operations.

### **Item 1A Risk Factors**

Risk Factors in Form 10-K incorporated by reference.

### **Item 2 Unregistered Sales of Equity Securities and Use of Proceeds**

None.

### **Item 3 Defaults Upon Senior Securities**

None.

### **Item 4 Mine Safety Disclosures**

Not applicable.

### **Item 5 Other Information**

None.

### **Item 6 Exhibits**

The exhibits filed as part of this report are listed on the Exhibit Index filed as part of this report.

## SIGNATURES

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

### Summit State Bank

(registrant)

November 12, 2015

*/s/ Thomas M. Duryea*

Date

Thomas M. Duryea  
President and Chief Executive Officer  
(Principal Executive Officer)

November 12, 2015

*/s/ Dennis E. Kelley*

Date

Dennis E. Kelley  
Senior Vice President and Chief Financial Officer  
(Principal Financial and Accounting Officer)

## EXHIBIT INDEX

Exhibit Number	Description
31.01	Certification of Principal Executive Officer pursuant to Rule 13a-14(a)/15d-14(a) as adopted pursuant to §302 of the Sarbanes-Oxley Act of 2002
31.02	Certification of Principal Financial and Accounting Officer pursuant to Rule 13a-14(a)/15d-14(a) as adopted pursuant to §302 of the Sarbanes-Oxley Act of 2002
32.01	Certification of Principal Executive Officer and Principal Financial and Accounting Officer pursuant to 18 U.S.C. §1350 as adopted pursuant to §906 of the Sarbanes-Oxley Act of 2002

## Exhibit 31.01

### Certification of Principal Executive Officer pursuant to Rule 13a-14(a)/15d-14(a) as adopted pursuant to §302 of the Sarbanes-Oxley Act of 2002

I, Thomas M. Duryea, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Summit State Bank (the registrant) for the quarter ended September 30, 2015;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiary, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusion about the effectiveness of the disclosure controls procedures, as of the end of the period covered by this report based on such evaluation; and
  - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors:
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

November 12, 2015

/s/ Thomas M. Duryea

Date

Thomas M. Duryea  
President and Chief Executive Officer  
(Principal Executive Officer)  
Summit State Bank

**Exhibit 31.02**

**Certification of Principal Financial and Accounting Officer pursuant to Rule 13a-14(a)/15d-14(a) as adopted pursuant to §302 of the Sarbanes-Oxley Act of 2002**

I, Dennis E. Kelley, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Summit State Bank (the registrant) for the quarter ended September 30, 2015;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiary, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors:
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

November 12, 2015                      /s/ Dennis E. Kelley

Date    Dennis E. Kelley  
Senior Vice President and Chief Financial Officer  
(Principal Financial and Accounting Officer)  
Summit State Bank

**EXHIBIT 32.01**

**Certification of Principal Executive Officer and Principal Financial and Accounting Officer pursuant to 18 U.S.C. §1350 as adopted pursuant to §906 of the Sarbanes-Oxley Act of 2002**

In connection with the quarterly report on Form 10-Q of Summit State Bank (the Registrant) for the quarter ended September 30, 2015, as filed with the Federal Deposit Insurance Corporation, the undersigned hereby certify pursuant to 18 U.S.C. §1350, as adopted pursuant to §906 of the Sarbanes-Oxley Act of 2002, that:

- 1) such Form 10-Q fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
  
- 2) the information contained in such Form 10-Q fairly presents, in all material respects, the financial condition and results of operations of the Registrant.

<u>November 12, 2015</u>	<u>/s/ Thomas M. Duryea</u>
Date	Thomas M. Duryea President and Chief Executive Officer (Principal Executive Officer)

<u>November 12, 2015</u>	<u>/s/ Dennis E. Kelley</u>
Date	Dennis E. Kelley Senior Vice President and Chief Financial Officer (Principal Financial and Accounting Officer)

This certification accompanies each report pursuant to §906 of the Sarbanes-Oxley Act of 2002 and shall not, except to the extent required by the Sarbanes-Oxley Act of 2002, be deemed filed by the Registrant for purposes of §18 of the Securities Exchange Act of 1934, as amended.