SIERRA BANCORP
Form 10-K
March 14, 2019
UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

Annual Report Pursuant to Section 13 or 15(d)

of the Securities Exchange Act of 1934

For the fiscal year ended December 31, 2018

Commission file number: 000-33063

SIERRA BANCORP

(Exact name of registrant as specified in its charter)

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

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

(559) 782-4900

Registrant’s telephone number, including area code

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

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

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

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

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

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

Yes No

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit such files).

Yes No

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

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

Large accelerated filer Accelerated filer

Non-accelerated filer

Smaller reporting company

Emerging growth company

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

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

As of June 29, 2018, the last business day of the registrant's most recently completed second fiscal quarter, the aggregate market value of the voting stock held by non-affiliates of the registrant was approximately $395 million, based on the closing price reported to the registrant on that date of $28.24 per share. Shares of Common Stock held

by each officer and director and each person or control group owning more than ten percent of the outstanding Common Stock have been excluded in that such persons may be deemed to be affiliates. This determination of affiliate status is not necessarily a conclusive determination for other purposes.

The number of shares of common stock of the registrant outstanding as of March 1, 2019 was 15,321,630.

Documents Incorporated by Reference: Portions of the definitive proxy statement for the 2019 Annual Meeting of Shareholders to be filed with the Securities and Exchange Commission pursuant to SEC Regulation 14A are incorporated by reference in Part III, Items 10-14.

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PART I

Item 1. Business

General

The Company

Sierra Bancorp (the "Company") is a California corporation headquartered in Porterville, California, and is a registered bank holding company under federal banking laws. The Company was formed to serve as the holding company for Bank of the Sierra (the "Bank"), and has been the Bank's sole shareholder since August 2001. The Company exists primarily for the purpose of holding the stock of the Bank and of such other subsidiaries it may acquire or establish. As of December 31, 2018, the Company's only other subsidiaries were Sierra Statutory Trust II, Sierra Capital Trust III, and Coast Bancorp Statutory Trust II, which were formed solely to facilitate the issuance of capital trust pass-through securities ("TRUPS"). Pursuant to the Financial Accounting Standards Board ("FASB") standard on the consolidation of variable interest entities, these trusts are not reflected on a consolidated basis in the financial statements of the Company. References herein to the "Company" include Sierra Bancorp and its consolidated subsidiary, the Bank, unless the context indicates otherwise. At December 31, 2018, the Company had consolidated assets of $2.523 billion (including gross loans of $1.732 billion), liabilities totaling $2.249 billion (including deposits of $2.116 billion), and shareholders' equity of $273 million. The Company's liabilities include $35 million in debt obligations due to its trust subsidiaries, related to TRUPS issued by those entities.

The Bank

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

There are not currently any plans for additional branches, but our post-recession branching activity includes the establishment of the Fresno-Palm branch and the purchase of the Lompoc branch in 2018, opening de novo branches in Bakersfield and Pismo Beach and the acquisition of the Woodlake branch in 2017, opening a new branch in Sanger in 2016, the relocation of our Clovis branch to a superior location in 2012, and the opening of a de novo branch in the City of Selma in 2011. With our latest acquisitions and branching activity, the Bank now maintains administrative offices and operates 40 full-service branches in the following California locations:

Porterville:	Administrative Headquarters	Main Office	West Olive Branch
	86 North Main Street	90 North Main Street	1498 West Olive Avenue
Arroyo Grande:	Arroyo Grande Office		
	1360 East Grand Avenue		
Atascadero:	Atascadero Office		
	7315 El Camino Real		
Bakersfield:	Bakersfield California Office	Bakersfield Riverlakes Office	Bakersfield Ming Office

	4456 California Ave	4060 Coffee Road	8500 Ming Avenue
	Bakersfield East Hills Office		
	2501 Mt. Vernon Avenue		
California City:	California City Office		
	8031 California City Blvd.		

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Clovis:	Clovis Office		
	1835 East Shaw Avenue		
Delano:	Delano Office		
	1126 Main Street		
Dinuba:	Dinuba Office		
	401 East Tulare Street		
Exeter:	Exeter Office		
	1103 West Visalia Road		
Farmersville:	Farmersville Office		
	400 West Visalia Road		
Fillmore:	Fillmore Office		
	527 Sespe Avenue		
Fresno:	Fresno Palm Office	Fresno Shaw Office	Fresno Sunnyside Office
	7391 North Palm Avenue	636 East Shaw Avenue	5775 E. Kings Canyon Rd.
Hanford:	Hanford Office		
	427 West Lacey Boulevard		
Lindsay:	Lindsay Office		
	142 South Mirage Avenue		
Lompoc:	Lompoc Office		
	705 West Central Avenue		
Ojai:	Ojai Office		
	402 West Ojai Avenue		
Paso Robles:	Paso Robles Office		
	1207 Spring Street		
Pismo Beach:	Pismo Beach Office		
	1401 Dolliver Street		
Reedley:	Reedley Office		
	1095 West Manning Ave.		
San Luis Obispo:	San Luis Obispo Office		
	500 Marsh Street		
Sanger:	Sanger Office		
	1500 7th Street		
Santa Barbara:	Santa Barbara Office		

	21 East Carrillo Street
Santa Clarita:	Santa Clarita Office
	26328 Citrus Street
Santa Paula:	Santa Paula Office
	901 East Main Street

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Selma:	Selma Office	
	2450 McCall Avenue	
Tehachapi:	Tehachapi Downtown Office	Tehachapi Old Town Office
	224 West “F” Street	21000 Mission Street
Three Rivers:	Three Rivers Office	
	40884 Sierra Drive	
Tulare:	Tulare Office	Tulare Prosperity Office
	246 East Tulare Avenue	1430 East Prosperity Avenue
Ventura:	Ventura Office	
	89 South California Street	
Visalia:	Visalia Mooney Office	Visalia Downtown Office
	2515 South Mooney Blvd.	128 East Main Street
Woodlake:	Woodlake Office	
	232 N. Valencia Boulevard	

Complementing the Bank’s stand-alone offices are specialized lending units which include our agricultural credit center and an SBA lending division. We also have ATMs at all branch locations and seven non-branch locations. Furthermore, the Bank is a member of the Allpoint network, which provides our deposit customers with surcharge-free access to over 43,000 ATMs across the nation and another 12,000 ATMs in foreign countries, and customers have access to electronic point-of-sale payment alternatives nationwide via the Pulse network. To ensure that account access preferences are addressed for all customers, we provide the following options: an internet branch which provides the ability to open deposit accounts online; an online banking option with bill-pay and mobile banking capabilities, including mobile check deposit; online lending solutions for consumers and small businesses; a customer service center that is accessible by toll-free telephone during business hours; and an automated telephone banking system that is usually accessible 24 hours a day, seven days a week. We offer a variety of other banking products and services to complement and support our lending and deposit products, including remote deposit capture and payroll services for business customers.

Our chief products and services relate to extending loans and accepting deposits. Our lending activities cover real estate, commercial (including small business), mortgage warehouse, agricultural, and consumer loans. The bulk of our real estate loans are secured by commercial, professional office and agricultural properties, but we also offer commercial construction loans and multifamily credit facilities among other types of loans. As noted above, gross loans totaled $1.732 billion at December 31, 2018, and the percentage of our total loan and lease portfolio for each of the principal types of credit we extend was as follows: (i) loans secured by real estate (84.0%); (ii) agricultural production loans (2.8%); (iii) commercial and industrial loans and leases (including SBA loans and direct finance leases) (7.4%); (iv) mortgage warehouse loans (5.3%); and (v) consumer loans (0.5%). Interest, fees, and other income on real-estate secured loans, which is by far the largest segment of our portfolio, totaled $73.0 million, or 64% of net interest plus other income in 2018, and $53.3 million, or 55% of net interest plus other income in 2017.

In addition to loans, we offer a wide range of deposit products and services for individuals and businesses including checking accounts, savings accounts, money market demand accounts, time deposits, retirement accounts, and sweep accounts. The Bank’s deposit accounts are insured by the Federal Deposit Insurance Corporation (the “FDIC”) up to maximum insurable amounts. We attract deposits throughout our market area via referrals from other customers,

direct-mail campaigns, a customer-oriented product mix, and competitive pricing, and by offering convenient locations, drive-through banking, and various other delivery channels. We strive to retain our deposit customers by providing a consistently high level of service. At December 31, 2018, the consolidated Company had 122,500 deposit accounts totaling $2.116 billion, compared to 118,700 deposit accounts totaling $1.988 billion at December 31, 2017.

We have not engaged in any material research activities related to the development of new products or services during the last two fiscal years. However, our officers and employees are continually searching for ways to increase public convenience, enhance customer access to payment systems, and enable us to improve our competitive position. The

cost to the Bank for these development, operations, and marketing activities cannot be calculated with any degree of certainty. We hold no patents or licenses (other than licenses required by bank regulatory agencies), franchises, or concessions. Our business has a modest seasonal component due to the heavy agricultural orientation of the Central Valley, but as our branch network has expanded to include more metropolitan areas we have become less reliant on the agriculture-related base. We are not dependent on a single customer or group of related customers for a material portion of our core deposits, but our time deposit balances at December 31, 2018 include $120 million in deposits from the State of California, comprising 6% of total deposits. Furthermore, for loans we have what could be considered to be concentrations in loans to the dairy industry (8% of total loans), and the hotel industry (9% of total loans). Our efforts to comply with government and regulatory mandates on consumer protection and privacy, anti-terrorism, and other initiatives have resulted in significant ongoing expense to the Bank, including compliance staffing costs and other expenses associated with compliance-related software. However, as far as can be determined there has been no material effect upon our capital expenditures, earnings, or competitive position as a result of environmental regulation at the Federal, state, or local level. The Company is not involved with chemicals or toxins that might have an adverse effect on the environment, thus its primary exposure to environmental legislation is through lending activities. The Company's lending procedures include steps to identify and monitor this exposure in an effort to avoid any related loss or liability.

Recent Developments

On May 18, 2018, the Company purchased most of the deposits of the Lompoc branch of Community Bank of Santa Maria, located in Santa Barbara County. The purchase also included the Lompoc branch building, the real property on which the building is located, and certain other equipment and fixed assets at their aggregate fair value of $1.7 million. The Lompoc branch is now operating as a full-service branch of Bank of the Sierra. Lompoc branch deposits totaled $38 million at the time of purchase, consisting of $32 million in non-maturity deposits and $6 million in time deposits. In accordance with GAAP, the Company recorded a $1.169 million deposit purchase premium in connection with the transaction and is amortizing that amount on a straight line basis over eight years.

On November 3, 2017 the Company acquired the Woodlake branch of Citizen's Business Bank. Woodlake branch deposits totaled approximately $27 million at the acquisition date, consisting largely of non-maturity deposits. The acquisition also included the purchase of the Woodlake branch building, the real property on which the building is located, and certain other equipment and fixed assets at their aggregate fair value of $500,000. In accordance with GAAP, the Company recorded $625,000 of goodwill and a $486,000 core deposit intangible in connection with the transaction. The core deposit intangible is being amortized on a straight line basis over eight years.

On October 1, 2017, the Company acquired 100% of the outstanding common shares of Ojai Community Bancorp, parent company to Ojai Community Bank (collectively referred to herein as "Ojai"), in exchange for $809,000 in cash and 1,376,431 shares of Sierra Bancorp stock. Immediately thereafter, Ojai Community Bank was merged into Bank of the Sierra. At the time of the acquisition, the fair value of Ojai's loans and deposits totaled $218 million and $231 million, respectively. In accordance with GAAP, the Company also recorded $18.5 million of goodwill and a $3.5 million core deposit intangible in connection with the transaction. The core deposit intangible is being amortized on a straight line basis over eight years. The conversion of Ojai's core banking system to Bank of the Sierra's core system took place on November 3, 2017.

Recent Accounting Pronouncements

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

Competition

The banking business in California is generally highly competitive, including in our market areas. Continued consolidation within the banking industry has heightened competition in recent periods, following on the heels of a

relatively large number of FDIC-assisted takeovers of failed banks and other acquisitions of troubled financial institutions in the aftermath of the Great Recession. There are also a number of unregulated companies competing for business in our markets, with financial products targeted at profitable customer segments. Many of those companies are able to compete across geographic boundaries and provide meaningful alternatives to banking products and services. These competitive trends are likely to continue.

With respect to commercial bank competitors, our business is dominated by a relatively small number of major banks that operate a large number of offices within our geographic footprint. Based on June 30, 2018 FDIC combined market share data for the 31 cities within which the Company currently maintains branches, the largest portion of deposits belongs to Wells Fargo Bank with 21.1% of total combined deposits, followed by Bank of America (18.8%), JPMorgan Chase (10.9%), Union Bank (8.5%), and Rabobank (5.6%). Bank of the Sierra ranks sixth on the 2018 market share list with 4.6% of total deposits. In Tulare County, however, where the Bank was originally formed, we rank first for deposit market share with 20.3% of total deposits at June 30, 2018, and had the largest number of branch locations (13, including our online branch). The larger banks noted above have, among other advantages, the ability to finance wide-ranging advertising campaigns and allocate their resources to regions of highest yield and demand. They can also offer certain services that we do not provide directly but may offer indirectly through correspondent institutions, and by virtue of their greater capitalization those banks have legal lending limits that are substantially higher than ours. For loan customers whose needs exceed our legal lending limits, we typically arrange for the sale, or participation, of some of the balances to financial institutions that are not within our geographic footprint.

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

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

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

Employees

As of December 31, 2018 the Company had 468 full-time and 88 part-time employees. On a full-time equivalent basis staffing stood at 541 at December 31, 2018, down from 556 at December 31, 2017.

Regulation and Supervision

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

Regulation of the Company Generally

The Company is a legal entity separate and distinct from the Bank and its other subsidiaries. As a bank holding company, the Company is regulated under the Bank Holding Company Act of 1956 (the "BHC Act"), and is subject to supervision, regulation and inspection by the Federal Reserve Board. The Company is also subject to certain provisions of the California Financial Code which are applicable to bank holding companies. In addition, the Company is under the jurisdiction of the SEC and is subject to the disclosure and regulatory requirements of the Securities Act

of 1933 and the Securities Exchange Act of 1934, each administered by the SEC. The Company's common stock is listed on the NASDAQ Global Select market ("NASDAQ") with "BSRR" as its trading symbol, and the Company is subject to the rules of NASDAQ for listed companies.

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

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

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

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

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

Regulation of the Bank Generally

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

Capital Adequacy Requirements

The Company and the Bank are subject to the regulations of the Federal Reserve Board and the FDIC, respectively, governing capital adequacy. These agencies have adopted risk-based capital guidelines to provide a systematic analytical framework that imposes regulatory capital requirements based on differences in risk profiles among

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

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

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

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

Based on our capital levels at December 31, 2018 and 2017, the Company and the Bank would have met all capital adequacy requirements under the Basel III Capital Rules on a fully phased-in basis. For more information on the Company's capital, see Part II, Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operation – Capital Resources. Risk-based capital ratio ("RBC") requirements are discussed in greater detail in the following section.

Prompt Corrective Action Provisions

Federal law requires each federal banking agency to take prompt corrective action to resolve the problems of insured financial institutions, including but not limited to those that fall below one or more of the prescribed minimum capital ratios. The federal banking agencies have by regulation defined the following five capital categories: “well capitalized” (Total RBC Ratio of 10%; Tier 1 RBC Ratio of 8%; Common Equity Tier 1 RBC Ratio of 6.5%; and Leverage Ratio of 5%); “adequately capitalized” (Total RBC Ratio of 8%; Tier 1 RBC Ratio of 6%; Common Equity Tier 1

RBC Ratio of 4.5%; and Leverage Ratio of 4%); “undercapitalized” (Total RBC Ratio of less than 8%; Tier 1 RBC Ratio of less than 6%; Common Equity Tier 1 RBC Ratio of less than 4.5%; or Leverage Ratio of less than 4%); “significantly undercapitalized” (Total RBC Ratio of less than 6%; Tier 1 RBC Ratio of less than 4%; Common Equity Tier 1 RBC Ratio of less than 3%; or Leverage Ratio less than 3%); and “critically undercapitalized” (tangible equity to total assets less than or equal to 2%). A bank may be treated as though it were in the next lower capital category if, after notice and the opportunity for a hearing, the appropriate federal agency finds an unsafe or unsound condition or practice merits a downgrade, but no bank may be treated as “critically undercapitalized” unless its actual tangible equity to assets ratio warrants such treatment. As of December 31, 2018 and 2017, both the Company and the Bank qualified as well capitalized for regulatory capital purposes.

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

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

Safety and Soundness Standards

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

The Dodd-Frank Wall Street Reform and Consumer Protection Act

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

Some aspects of Dodd-Frank are still subject to rulemaking, making it difficult to anticipate the ultimate financial impact on the Company, its customers or the financial services industry more generally. However, many provisions of Dodd-Frank are already affecting our operations and expenses, including but not limited to changes in FDIC assessments, the permitted payment of interest on demand deposits, and enhanced compliance requirements. Some

of the rules and regulations promulgated or yet to be promulgated under Dodd-Frank will apply directly only to institutions much larger than ours, but could indirectly impact smaller banks, either due to competitive influences or because certain required practices for larger institutions may subsequently become expected "best practices" for smaller institutions. We could see continued attention and resources devoted by the Company to ensure compliance with the statutory and regulatory requirements engendered by Dodd-Frank.

Tax Cuts and Jobs Act

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

Deposit Insurance

The Bank's deposits are insured up to maximum applicable limits under the Federal Deposit Insurance Act, and the Bank is subject to deposit insurance assessments to maintain the FDIC's Deposit Insurance Fund (the "DIF"). In October 2010, the FDIC adopted a revised restoration plan to ensure that the DIF's designated reserve ratio ("DRR") reaches 1.35% of insured deposits by September 30, 2020, the deadline mandated by the Dodd-Frank Act. In August 2016 the FDIC announced that the DIF reserve ratio had surpassed 1.15% as of June 30, 2016 and assessment rates for most institutions were adjusted downward, but institutions with $10 billion or more in assets were assessed a quarterly surcharge which will continue until the reserve ratio reaches the statutory minimum of 1.35%. Furthermore, the restoration plan proposed an increase in the DRR to 2% of estimated insured deposits as a long-term goal for the fund. On September 30, 2018, the DIF ratio reached 1.36 percent. Because the ratio exceeded 1.35 percent, two deposit insurance assessment changes occurred under FDIC regulations: surcharges on large banks (total consolidated assets of $10 billion or more) ended, with the last surcharge on large banks being collected on December 28, 2018; and, banks with total consolidated assets of less than $10 billion were awarded credits for the portion of their assessments that contributed to the growth in the reserve ratio from 1.15 percent to 1.35 percent, to be applied when the reserve ratio is at least 1.38 percent. Bank of the Sierra is eligible for such credits, which could reduce our FDIC assessments in future periods.

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

In addition to DIF assessments, banks have been required to pay quarterly assessments that are applied to the retirement of Financing Corporation bonds issued in the 1980's to assist in the recovery of the savings and loan industry. The assessment amount fluctuates, but was 0.32 basis points of insured deposits for the fourth quarter of 2018. The Financing Corporation bonds mature in September 2019, and a final assessment of 0.14 basis points of insured deposits is projected for March 2019.

Community Reinvestment Act

The Bank is subject to certain requirements and reporting obligations involving Community Reinvestment Act ("CRA") activities. The CRA generally requires federal banking agencies to evaluate the record of a financial institution in meeting the credit needs of its local communities, including low and moderate income neighborhoods. The CRA further requires the agencies to consider a financial institution's efforts in meeting its community credit needs when evaluating applications for, among other things, domestic branches, mergers or acquisitions, or the formation of

holding companies. In measuring a bank's compliance with its CRA obligations, the regulators utilize a performance-based evaluation system under which CRA ratings are determined by the bank's actual lending, service, and investment performance, rather than on the extent to which the institution conducts needs assessments, documents community outreach activities or complies with other procedural requirements. In connection with its assessment of CRA performance, the FDIC assigns a rating of "outstanding," "satisfactory," "needs to improve" or "substantial noncompliance." The Bank most recently received a satisfactory CRA assessment rating in January 2019.

Privacy and Data Security

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

Overdrafts

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

Consumer Financial Protection and Financial Privacy

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

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

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

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

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

Identity Theft

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

Interstate Banking and Branching

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

USA Patriot Act of 2001

The impact of the USA Patriot Act of 2001 (the "Patriot Act") on financial institutions of all kinds has been significant and wide ranging. The Patriot Act substantially enhanced anti-money laundering and financial transparency laws, and required certain regulatory authorities to adopt rules that promote cooperation among financial institutions, regulators, and law enforcement entities in identifying parties that may be involved in terrorism or money laundering. Under the Patriot Act, financial institutions are subject to prohibitions regarding specified financial transactions and account relationships, as well as enhanced due diligence and "know your customer" standards in their dealings with foreign

financial institutions and foreign customers. The Patriot Act also requires all financial institutions to establish anti-money laundering programs. The Bank expanded its Bank Secrecy Act compliance staff and intensified due diligence procedures concerning the opening of new accounts to fulfill the anti-money laundering requirements of the Patriot Act, and also implemented systems and procedures to identify suspicious banking activity and report any such activity to the Financial Crimes Enforcement Network.

Incentive Compensation

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

Sarbanes-Oxley Act of 2002

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

Commercial Real Estate Lending Concentrations

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

Other Pending and Proposed Legislation

Other legislative and regulatory initiatives which could affect the Company, the Bank and the banking industry in general are pending, and additional initiatives may be proposed or introduced before the United States Congress, the California legislature and other governmental bodies in the future. Such proposals, if enacted, may further alter the

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

Item 1A. RISK FACTORS

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

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

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

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

California's San Joaquin Valley, where the Company is headquartered and has many of its branch locations, was particularly hard hit by the most recent adverse economic cycle. Unemployment levels have historically been elevated in the San Joaquin Valley, including Tulare County which is our geographic center, but recessionary conditions pushed unemployment rates to exceptionally high levels. The unemployment rate for Tulare County reached a high of 19.3% in March 2010. It reflects a steady downward trend since 2010 and had declined to 9.6% by December 2018, but is still well above the 4.2% aggregate unemployment rate reported for California in December 2018. In addition, as discussed below in connection with challenges to the agricultural industry, the persistence of a California drought could have a significant negative impact on unemployment rates in our market areas. Furthermore, a drop in oil prices like the decline experienced in recent years could also negatively impact unemployment rates, particularly in Kern County.

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

- a lack of demand for loans, or other products and services offered by us;
- a decline in the value of our loans or other assets secured by real estate;
- a decrease in deposit balances due to increased pressure on the liquidity of our customers;
- an impairment of our investment securities; or
- an increase in the number of borrowers who become delinquent, file for protection under bankruptcy laws or default on their loans or other obligations to us, which in turn could result in higher levels of nonperforming assets, net charge-offs and provisions for credit losses.

Challenges in the agricultural industry could have an adverse effect on our customers and their ability to make payments to us, particularly in view of recent drought conditions in California and disruptions involving international

trade. While the Company’s nonperforming assets are currently comprised mainly of other real estate owned (“OREO”) and loans secured by non-agricultural real estate, difficulties experienced by the agricultural

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industry have led to relatively high levels of nonperforming assets in previous economic cycles. This is due to the fact that a considerable portion of our borrowers are involved in, or are impacted to some extent by, the agricultural industry. While a great number of our borrowers are not directly involved in agriculture, they would likely be impacted by difficulties in the agricultural industry since many jobs in our market areas are ancillary to the regular production, processing, marketing and sale of agricultural commodities.

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

Another significant drop in oil prices could have an adverse impact on our customers and their ability to make payments to us, particularly in areas such as Kern County where oil production is a key economic driver. As we have experienced in the past, a drop in oil prices could lead to declines in property values and property taxes, particularly in Kern County, which is home to about three quarters of California’s oil production. The Company does not have direct exposure to oil producers, and our exposure via loans outstanding to borrowers involved in servicing oil companies totaled only $14 million at December 31, 2018. However, if cash flows are disrupted for our energy-related borrowers, or if other borrowers are indirectly impacted and/or non-oil property values decline, our level of nonperforming assets and loan charge-offs could increase. Furthermore, economic multipliers to a contracting oil industry include the prospects of a depressed residential housing market and a drop in commercial real estate values.

Concentrations of real estate loans have negatively impacted our performance in the past, and could subject us to further risks in the event of another real estate recession or natural disaster. Our loan portfolio is heavily concentrated in real estate loans, particularly commercial real estate. At December 31, 2018, 84% of our loan portfolio consisted of real estate loans, and a sizeable portion of the remaining loan portfolio had real estate collateral as a secondary source of repayment or as an abundance of caution. Loans on commercial buildings represented approximately 51% of all real estate loans, while construction/development and land loans were 15%, loans secured by residential properties accounted for 24%, and loans secured by farmland were 10% of real estate loans. The Company’s $6.2 million balance of nonperforming assets at December 31, 2018 includes nonperforming real estate loans totaling $3.6 million, and $1.1 million in OREO.

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

real estate secured loans and negatively impact our results of operations.

Moreover, banking regulators give commercial real estate loans extremely close scrutiny due to risks relating to the cyclical nature of the real estate market and risks for lenders with high concentrations of such loans. The regulators have required banks with relatively high levels of CRE loans to implement enhanced underwriting standards, internal

controls, risk management policies and portfolio stress testing, which has resulted in higher allowances for possible loan losses. Expectations for higher capital levels have also emerged. Any required increase in our allowance for loan losses could adversely affect our net income, and any requirement that we maintain higher capital levels could adversely impact financial performance measures including earnings per share and return on equity.

Our concentration of commercial real estate, construction and land development, and commercial and industrial loans exposes us to increased lending risks. Commercial and agricultural real estate, commercial construction and land development, and commercial and industrial loans and leases (including agricultural production loans but excluding mortgage warehouse loans), which comprised approximately 68% of our total loan portfolio as of December 31, 2018, expose the Company to a greater risk of loss than residential real estate and consumer loans, which were a smaller percentage of the total loan portfolio. Commercial real estate and land development loans typically involve relatively large balances to a borrower or a group of related borrowers, and an adverse development with respect to a larger commercial loan relationship would expose us to greater risk of loss than would issues involving a smaller residential mortgage loan or consumer loan.

Repayment of our commercial loans is often dependent on the cash flows of the borrowers, which may be unpredictable, and the collateral securing these loans may fluctuate in value. At December 31, 2018, we had $177 million, or 10% of total loans, in commercial loans and leases (including agricultural production loans but excluding mortgage warehouse loans). Commercial lending involves risks that are different from those associated with real estate lending. Real estate lending is generally considered to be collateral based lending with loan amounts based on predetermined loan to collateral values, and liquidation of the underlying real estate collateral being viewed as the primary source of repayment in the event of borrower default. Our commercial loans are primarily extended based on the cash flows of the borrowers, and secondarily on any underlying collateral provided by the borrowers. A borrower's cash flows may be unpredictable, and collateral securing those loans may fluctuate in value. Although commercial loans are often collateralized by equipment, inventory, accounts receivable, or other business assets, the liquidation of such collateral in the event of default is often an insufficient source of repayment for a number of reasons, including uncollectible accounts receivable and obsolete or special-purpose inventories among others.

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

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

- historical experience with our loans;

- our evaluation of economic conditions;
- regular reviews of the quality, mix and size of the overall loan portfolio;
- a detailed cash flow analysis for nonperforming loans;

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- regular reviews of delinquencies; and
- the quality of the collateral underlying our loans.

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

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

Our expenses could increase as a result of increases in FDIC insurance premiums or other regulatory assessments. The FDIC charges insured financial institutions a premium to maintain the DIF at a certain level. In the event that deteriorating economic conditions increase bank failures, the FDIC ensures payments of deposits up to insured limits from the DIF. Although the Bank's FDIC insurance assessments have not increased as a result of changes in recent periods, and could possibly even be reduced in the near term, there can be no assurance that the FDIC will not increase assessment rates in the future or that the Bank will not be subject to higher assessment rates as a result of a change in its risk category, either of which could have an adverse effect on the Bank’s earnings.

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

Moreover, with the large number of bank failures in the past decade some customers have become more concerned about the extent to which their deposits are insured by the FDIC. Customers may withdraw deposits in an effort to ensure that the amount they have on deposit with their bank is fully insured. Decreases in deposits may adversely affect our funding costs and net income. Ultimately, competition can and does increase our cost of funds, reduce loan

yields and drive down our net interest margin, thereby reducing profitability. It can also make it more difficult for us to continue to increase the size of our loan portfolio and deposit base, and could cause us to rely more heavily on wholesale borrowings which are generally more expensive than retail deposits.

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

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

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

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

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

If our information systems were to experience a system failure, our business and reputation could suffer. We rely heavily on communications and information systems to conduct our business. The computer systems and network infrastructure we use could be vulnerable to unforeseen problems. Our operations are dependent upon our ability to minimize service disruptions by protecting our computer equipment, systems, and network infrastructure from physical damage due to fire, power loss, telecommunications failure or a similar catastrophic event. We have protective measures in place to prevent or limit the effect of the failure or interruption of our information systems, and

will continue to upgrade our security technology and update procedures to help prevent such events. However, if such failures or interruptions were to occur, they could result in damage to our reputation, a loss of customers, increased regulatory scrutiny, or possible exposure to financial liability, any of which could have a material adverse effect on our financial condition and results of operations.

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

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

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

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

Further, we may be required to invest significant management attention and resources to evaluate and make any changes necessary to comply with new statutory and regulatory requirements under the Dodd-Frank Act, which could negatively impact our results of operations and financial condition. We cannot predict whether there will be

additional laws or reforms that would affect the U.S. financial system or financial institutions, when such changes may be

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adopted, how such changes may be interpreted and enforced or how such changes may affect us. However, the costs of complying with any additional laws or regulations could have a material adverse effect on our financial condition and results of operations.

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

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

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

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

One significant pronouncement is ASU 2016-13, which was released by the FASB in 2016 and which the Company is required to adopt no later than January 1, 2020. ASU 2016-13 includes changes to the methodology for determining the amount of the allowance for credit losses, among other things. The new credit loss model will be a substantial change from the standard in place today, as it requires the Company to calculate its allowance on the basis of current expected credit losses over the lifetime of its loans (commonly referred to as the "CECL" model), instead of losses inherent in the portfolio as of a point in time. On the effective date, institutions will record a cumulative-effect

balance sheet adjustment for financial assets carried at amortized cost for any change in the related allowance for loan and lease losses generated by the adoption of the new standard. The Company's preliminary evaluation indicates that when adopted, the provisions of ASU 2016-13 will impact our consolidated financial statements, particularly the level of our reserve for credit losses and shareholders' equity, which could materially affect our financial condition and

future results of operations. See Note 2 to the consolidated financial statements under "Recent Accounting Pronouncements" for additional details on ASU 2016-13 and its expected impact on the Company.

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

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

We depend on our executive officers and key personnel to implement our business strategy, and could be harmed by the loss of their services. We believe that our continued growth and success depends in large part upon the skills of our management team and other key personnel. The competition for qualified personnel in the financial services industry is intense, and the loss of key personnel or an inability to attract, retain or motivate key personnel could adversely affect our business. If we are not able to retain our existing key personnel or attract additional qualified personnel, our business operations could be impaired.

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

We are exposed to the risk of environmental liabilities with respect to properties to which we obtain title. Approximately 84% of our loan portfolio at December 31, 2018 consisted of real estate loans. In the normal course of business we may foreclose and take title to real estate collateral, and could be subject to environmental liabilities with respect to those properties. We may be held liable to a governmental entity or to third parties for property damage, personal injury, investigation and clean-up costs incurred by these parties in connection with environmental contamination, or may be required to investigate or clean up hazardous or toxic substances, or chemical releases at a property. The costs associated with investigation or remediation activities could be substantial. In addition, if we are the owner or former owner of a contaminated site, we may be subject to common law claims by

third parties based on damages and costs resulting from environmental contamination emanating from the property. These costs and claims could adversely affect our business and prospects.

Risks Related to our Common Stock

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

- actual or anticipated fluctuations in our operating results and financial condition;
- changes in revenue or earnings estimates or publication of research reports and recommendations by financial analysts;
- failure to meet analysts' revenue or earnings estimates;
- speculation in the press or investment community;
- strategic actions by us or our competitors, such as acquisitions or restructurings;
- actions by shareholders;
- sales of our equity or equity-related securities, or the perception that such sales may occur;
- fluctuations in the trading volume of our common stock;
- fluctuations in the stock prices, trading volumes, and operating results of our competitors;
- market conditions in general and, in particular, for the financial services industry;
- proposed or adopted regulatory changes or developments;
- regulatory action against us;
- actual, anticipated or pending investigations, proceedings, or litigation that involve or affect us; and
- domestic and international economic factors unrelated to our performance.

The stock market and, more specifically, the market for financial institution stocks, has experienced significant volatility in the past, including in the latter part of 2018. As a result, the market price of our common stock has at times been unpredictable and could be in the future, as well. The capital and credit markets have also experienced volatility and disruption over the past several years, at times reaching unprecedented levels. In some cases, the markets have produced downward pressure on stock prices and adversely impacted credit availability for certain issuers without regard to the issuers' underlying financial strength.

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

Future acquisitions may dilute shareholder ownership and value, especially tangible book value per share. We periodically evaluate opportunities to acquire other financial institutions and/or bank branches, and could incorporate such acquisitions as part of our future growth strategy. Such acquisitions may involve cash, debt, and/or equity securities. Acquisitions typically involve the payment of a premium over book and market values, and, therefore, some dilution of our tangible book value per common share may occur in connection with any future acquisitions. To

the extent we issue capital stock in connection with such transactions, the share ownership of our existing shareholders may be diluted.

The Company relies heavily on the payment of dividends from the Bank. Other than $2.3 million in cash available at the holding company level at December 31, 2018, the Company's ability to meet debt service requirements and pay dividends depends on the Bank's ability to pay dividends to the Company, as the Company has no other source of significant income. However, the Bank is subject to regulations limiting the amount of dividends it may pay. For example, the payment of dividends by the Bank is affected by the requirement to maintain adequate capital pursuant to the capital adequacy guidelines issued by the Federal Deposit Insurance Corporation. If (i) any capital requirements are increased; and/or (ii) the total risk-weighted assets of the Bank increase significantly; and/or (iii) the Bank's income declines significantly, the Bank's Board of Directors may decide or be required to retain a greater portion of the Bank's earnings to achieve and maintain the required capital or asset ratios. This would reduce the amount of funds available for the payment of dividends by the Bank to the Company. Further, one or more of the Bank's regulators could prohibit the Bank from paying dividends if, in their view, such payments would constitute unsafe or unsound banking practices. The Bank's ability to pay dividends to the Company is also limited by the California Financial Code. Whether dividends are paid, and the frequency and amount of such dividends will also depend on the financial condition and performance of the Bank and the decision of the Bank's Board of Directors. Information concerning the Company's dividend policy and historical dividend practices is set forth in Item 5 below under "Dividends." However, no assurance can be given that our future performance will justify the payment of dividends in any particular year.

Your investment may be diluted because of our ability to offer stock to others, and from the exercise of stock options. The shares of our common stock do not have preemptive rights, which means that you may not be entitled to buy additional shares if shares are offered to others in the future. We are authorized to issue up to 24,000,000 shares of common stock, and as of December 31, 2018 we had 15,300,460 shares of common stock outstanding. Except for certain limitations imposed by NASDAQ, nothing restricts our ability to offer additional shares of stock for fair value to others in the future. Any issuances of common stock would dilute our shareholders' ownership interests and may dilute the per share book value of our common stock. Furthermore, when our directors and officers exercise in-the-money stock options your ownership in the Company is diluted. As of December 31, 2018, there were outstanding options to purchase an aggregate of 453,020 shares of our common stock with an average exercise price of $18.45 per share. At the same date there were an additional 767,000 shares available to grant under our 2017 Stock Incentive Plan.

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

The holders of our debentures have rights that are senior to those of our shareholders. In 2004 we issued $15,464,000 of junior subordinated debt securities due March 17, 2034, and in 2006 we issued an additional $15,464,000 of junior subordinated debt securities due September 23, 2036 in order to supplement regulatory capital. Moreover, the Coast Bancorp acquisition included $7,217,000 of junior subordinated debt securities due December 15, 2037. All of these junior subordinated debt securities are senior to the shares of our common stock. As a result, we must make interest payments on the debentures before any dividends can be paid on our common stock, and in the event of our bankruptcy, dissolution or liquidation, the holders of debt securities must be paid in full before any distributions may be made to the holders of our common stock. In addition, we have the right to defer interest payments on the junior

subordinated debt securities for up to five years, during which time no dividends may be paid to holders of our common stock. In the event that the Bank is unable to pay dividends to us, we may be unable to pay the amounts due to the holders of the junior subordinated debt securities and thus would be unable to declare and pay any dividends on our common stock.

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

ITEM 1B. UNRESOLVED STAFF COMMENTS

Not applicable.

Item 2. Properties

The Company's administrative headquarters is housed in a 37,000 square foot, three-story office building located at 86 North Main Street, Porterville, California, and our main office consists of a one-story brick building located at 90 N. Main Street, Porterville, California, adjacent to our administrative headquarters. Both of those buildings are situated on unencumbered property owned by the Company. The Company also owns unencumbered property on which 18 of our other offices are located, namely the following branches: Bakersfield Ming, California City, Dinuba, Exeter, Farmersville, Fresno Shaw, Hanford, Lindsay, Lompoc, Porterville West Olive, San Luis Obispo, Santa Paula, Tehachapi Downtown, Tehachapi Old Town, Three Rivers, Tulare, Visalia Mooney and Woodlake. The remaining branches, as well as our technology center and remote ATM locations, are leased from unrelated parties. Management believes that existing back-office facilities are adequate to accommodate the Company's operations for the immediately foreseeable future.

Item 3. Legal Proceedings

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

Item 4. MINE SAFETY DISCLOSURES

Not applicable.

PART II

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

(a) Market Information

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

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

Calendar Quarter End	Sale Price Of The Company's Common Stock High	Low	Approximate Trading Volumes Shares
March 31, 2017	29.50	25.06	3,199,738
June 30, 2017	27.86	23.10	2,107,112
September 30, 2017	28.03	23.29	1,904,551
December 31, 2017	28.87	24.32	2,368,197
March 31, 2018	28.70	25.42	1,557,545
June 30, 2018	29.96	25.72	1,666,047
September 30, 2018	31.18	28.03	2,576,212
December 31, 2018	29.02	22.94	2,598,735

(b) Holders

As of January 31, 2019 there were an estimated 4,824 shareholders of the Company's Common Stock. There were 695 registered holders of record on that date, and per Broadridge, an investor communication company, there were 4,129 beneficial holders with shares held under a street name, including "objecting beneficial owners" whose names and addresses are unavailable. Since some holders maintain multiple accounts, it is likely that the above numbers overstate the actual number of the Company's shareholders.

(c) Dividends

The Company paid cash dividends totaling $9.8 million, or $0.64 per share in 2018 and $7.9 million, or $0.56 per share in 2017, which represents 33% of annual net earnings for 2018 and 41% for 2017. The Company's general dividend policy is to pay cash dividends within the range of typical peer payout ratios, provided that such payments do not adversely affect the Company's financial condition and are not overly restrictive to its growth capacity. However, in the past when many of our peers elected to suspend dividend payments, the Company's Board determined that we should continue to pay a certain level of dividends without regard to peer payout ratios, as long as our core operating performance was adequate and policy or regulatory restrictions did not preclude such payments. That said, no assurance can be given that our financial performance in any given year will justify the continued payment of a certain level of cash dividend, or any cash dividend at all.

As a bank holding company that currently has no significant assets other than its equity interest in the Bank, the Company's ability to declare dividends depends upon cash on hand as supplemented by dividends from the Bank. The Bank's dividend practices in turn depend upon the Bank's earnings, financial position, regulatory standing, ability to meet current and anticipated regulatory capital requirements, and other factors deemed relevant by the Bank's Board of Directors. The authority of the Bank's Board of Directors to declare cash dividends is also subject to statutory restrictions. Under California banking law, the Bank may at any time declare a dividend in an amount not to exceed

the lesser of (i) its retained earnings, or (ii) its net income for the last three fiscal years reduced by distributions to the Bank's shareholder during such period. However, with the prior approval of the California Commissioner of Business Oversight the Bank may declare a larger dividend, in an amount not exceeding the greatest of (i) the retained earnings of the Bank, (ii) the net income of the Bank for its last fiscal year, or (iii) the net income of the Bank for its current fiscal year.

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

(d) Securities Authorized for Issuance under Equity Compensation Plans

The following table provides information as of December 31, 2018 with respect to options outstanding and available under our 2017 Stock Incentive Plan and the now-terminated 2007 Stock Incentive Plan, which are our only equity compensation plans other than an employee benefit plan meeting the qualification requirements of Section 401(a) of the Internal Revenue Code:

Plan Category	Number of Securities to be Issued Upon Exercise of Outstanding Options	Weighted-Average Exercise Price of Outstanding Options	Number of Securities Remaining Available for Future Issuance
Equity compensation plans approved by security holders	453,020	$18.45	767,000

(e) Performance Graph

Below is a five-year performance graph comparing the cumulative total return on the Company's common stock to the cumulative total returns of the NASDAQ Composite Index (a broad equity market index), the SNL Bank Index, and the SNL $1 billion to $5 billion Bank Index (the latter two qualifying as peer bank indices), assuming a $100 investment on December 31, 2013 and the reinvestment of dividends.

	Period Ending					
Index	12/31/13	12/31/14	12/31/15	12/31/16	12/31/17	12/31/18
Sierra Bancorp	100.00	111.43	114.91	177.96	181.55	168.05
NASDAQ Composite Index	100.00	114.75	122.74	133.62	173.22	168.30
SNL Bank $1B-$5B Index	100.00	104.56	117.04	168.38	179.51	157.27
SNL Bank Index	100.00	111.79	113.69	143.65	169.64	140.98

Source: S&P Global Market Intelligence

(f) Stock Repurchases

In September 2016 the Board authorized 500,000 shares of common stock for repurchase, subsequent to the completion of previous stock buyback plans. The authorization of shares for repurchase does not provide assurance that a specific quantity of shares will be repurchased, and the program may be suspended at any time at Management's discretion. The Company did not repurchase any shares in the fourth quarter of 2018, and there were 478,954 authorized shares remaining available for repurchase at December 31, 2018. As of the date of this report, Management has no immediate plans to resume stock repurchase activity.

Item 6. Selected Financial Data

The following table presents selected historical financial information concerning the Company, which should be read in conjunction with our audited consolidated financial statements, including the related notes, and "Management's Discussion and Analysis of Financial Condition and Results of Operations" included elsewhere herein. The selected financial data as of December 31, 2018 and 2017, and for each of the years in the three year period ended December 31, 2018, is derived from our audited consolidated financial statements and related notes which are included in this Annual Report. The selected financial data presented for earlier years is from our audited financial statements which are not included in this Annual Report. Throughout this Annual Report, information is for the consolidated Company unless otherwise stated.

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

	As of and for the years ended December 31,				
Operating Data	2018	2017	2016	2015	2014
Interest income	$101,638	$80,924	$68,505	$62,707	$55,121
Interest expense	9,244	5,223	3,323	2,581	2,796
Net interest income before provision for loan losses	92,394	75,701	65,182	60,126	52,325
(Benefit) provision for loan losses	4,350	(1,140)	—	—	350
Non-interest income	21,564	21,779	19,238	17,715	15,831
Non-interest expense	70,024	65,441	58,053	50,703	—
Income before provision for income taxes	39,584	33,179	26,367	27,138	21,431
Provision for income taxes	9,907	13,640	8,800	9,071	6,191
Net income	29,677	19,539	17,567	18,067	15,240
Selected Balance Sheet Summary					
Total loans, net	1,724,780	1,551,551	1,255,754	1,124,602	961,056
Allowance for loan losses	9,750	9,043	9,701	10,423	11,248
Securities available for sale	560,479	558,329	530,083	507,582	511,883
Cash and due from banks	74,132	70,137	120,442	48,623	50,095
Foreclosed assets	1,082	5,481	2,225	3,193	3,991
Premises and equipment, net	29,500	29,388	28,893	21,990	21,853
Total interest-earning assets	2,286,952	2,118,875	1,827,192	1,634,180	1,474,629
Total assets	2,522,502	2,340,298	2,032,873	1,796,537	1,637,320
Total interest-bearing liabilities	1,561,039	1,417,590	1,277,416	1,150,010	1,038,177
Total deposits	2,116,340	1,988,386	1,695,471	1,464,628	1,366,695
Total liabilities	2,249,478	2,084,356	1,826,995	1,606,197	1,450,229
Total shareholders' equity	273,024	255,942	205,878	190,340	187,091
Per Share Data					
Net income per basic share	1.94	1.38	1.30	1.34	1.09
Net income per diluted share	1.92	1.36	1.29	1.33	1.08
Book value	17.84	16.81	14.94	14.36	13.67
Cash dividends	0.64	0.56	0.48	0.42	0.34
Weighted average common shares outstanding basic	15,261,794	14,172,196	13,530,293	13,460,605	14,001,958
Weighted average common shares outstanding diluted	15,432,120	14,357,782	13,651,804	13,585,110	14,136,486
Key Operating Ratios:					
Performance Ratios: [1]					
Return on average equity	11.37 %	8.82 %	8.71 %	9.59 %	8.18 %
Return on average assets	1.23 %	0.93 %	0.95 %	1.07 %	1.03 %
Net interest spread (tax-equivalent) [4]	4.03 %	3.90 %	3.86 %	3.92 %	3.92 %
Net interest margin (tax-equivalent)	4.24 %	4.04 %	3.95 %	3.99 %	4.01 %
Dividend payout ratio	32.99 %	40.61 %	36.97 %	31.29 %	31.33 %
Equity to assets ratio	10.80 %	10.53 %	10.93 %	11.13 %	12.58 %
Efficiency ratio (tax-equivalent)	60.79 %	65.52 %	67.23 %	63.98 %	66.30 %
Net loans to total Deposits at Period end	81.50 %	78.03 %	74.07 %	70.32 %	70.32 %
Asset Quality Ratios: [1]					

Non-performing loans to total loans [2]	0.30	%	0.25	%	0.50	%	0.85	%	2.13	%
Non-performing assets to total loans and other real estate owned [2]	0.36	%	0.60	%	0.68	%	1.13	%	2.53	%
Net (recoveries) charge-offs to average loans	0.22	%	-0.04	%	0.06	%	0.08	%	0.09	%
Allowance for loan losses to net loans at period end	-0.57	%	-0.58	%	-0.77	%	-0.93	%	-1.17	%
Allowance for Loan Losses to Non-Performing Loans	-189.10	%	-228.19	%	-152.41	%	-108.19	%	-54.40	%
Regulatory Capital Ratios: [3]										
Common equity tier 1 capital to risk-weighted assets	12.61	%	12.84	%	14.09	%	N/A		N/A	
Tier 1 capital to adjusted average assets (leverage ratio)	11.49	%	11.32	%	11.92	%	12.99	%	12.99	%
Tier 1 capital to risk-weighted assets	14.38	%	14.79	%	16.53	%	17.39	%	17.39	%
Total capital to risk-weighted assets	14.89	%	15.32	%	17.25	%	18.44	%	18.44	%

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

[2] Performing TDR’s are not included in nonperforming loans and are therefore not included in the numerators used to calculate these ratios.

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

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

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

This discussion presents Management's analysis of the Company's financial condition as of December 31, 2018 and 2017, and the results of operations for each year in the three-year period ended December 31, 2018. The discussion should be read in conjunction with the Company's consolidated financial statements and the notes related thereto presented elsewhere in this Form 10-K Annual Report (see Item 8 below).

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

Critical Accounting Policies

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

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

Overview of the Results of Operations and Financial Condition

Results of Operations Summary

The Company recognized net income of $29.677 million in 2018, relative to $19.539 million in 2017 and $17.567 million in 2016. Net income per diluted share was $1.92 in 2018, as compared to $1.36 in 2017 and $1.29 for 2016. The Company's return on average assets and return on average equity were 1.23% and 11.37%, respectively, in 2018, as compared to 0.93% and 8.82%, respectively, in 2017 and 0.95% and 8.71%, respectively, for 2016. Our operating results and balance sheet have been materially impacted in recent periods by whole-bank acquisitions and nonrecurring items, as discussed in greater detail in the applicable sections below. Furthermore, the Company's financial performance was favorably affected by a substantially lower corporate income tax rate starting in 2018, but was negatively impacted in 2017 by a $2.710 million charge to our income tax provision as we revalued our net deferred tax asset to reflect the lower income tax rate enacted at the end of the year. Excluding the impact of nonrecurring items, our core financial results have been trending better for the past several years due in part to a

higher volume of loans, a strong base of core deposits, and reductions in nonperforming assets. The following is a summary of the major factors that impacted the Company's results of operations for the years presented in the consolidated financial statements.

- Net interest income improved by 22% in 2018 over 2017 and 16% in 2017 over 2016, due primarily to growth in average interest-earning assets. The increase in average earning assets in 2018 over 2017 was largely organic, resulting from concerted business development efforts and lending opportunities inherent in expanded markets. The increase in 2017 over 2016 was the result of our acquisitions of Coast National Bank in mid-2016 and Ojai Community Bank in the fourth quarter of 2017, organic loan growth, and a higher level of investments. The positive impact of asset growth was enhanced by net interest margin expansion of 20 basis points in 2018 and nine basis points in 2017, resulting in part from short-term interest rate increases, discount accretion on acquisition loans, and a favorable shift in our mix of interest-earning assets. Net interest income has also been impacted by nonrecurring interest items, which added $277,000 to interest income in 2018 relative to $736,000 in 2017 and $563,000 in 2016.
- We recorded a loan loss provision of $4.350 million in 2018, relative to a negative provision of $1.140 million in 2017 and no provision for 2016. The 2018 provision was deemed necessary subsequent to our determination of the appropriate level for our allowance for loan and lease losses, taking into consideration overall credit quality, growth in outstanding loan balances, and reserves required for specifically identified impaired loan balances (including $2.4 million for a large purchased participation loan that was placed on non-accrual status in the third quarter). The provision reversal in 2017 was made possible by principal recovered on charged-off loan balances, and the zero provision for 2016 was facilitated by the reduction of impaired loan balances, lower loan losses, and tighter underwriting standards for new and renewed loans.
- Noninterest income fell by $215,000, or 1%, in 2018 over 2017, but improved by $2.541 million, or 13%, in 2017 compared to 2016. The decline in 2018 occurred as gains in deposit service charges, debit card interchange income, and other fees were offset by lower income from bank-owned life insurance (“BOLI”) associated with deferred compensation plans, and a drop in nonrecurring income including the impact of an expense amortization adjustment on our tax credit investments (reflected as an offset to income). The improvement in 2017 is comprised primarily of growth in service charges on deposit accounts and other core fee income, but also includes nonrecurring items as discussed below.
- Operating expense increased by $4.583 million, or 7%, in 2018 over 2017, and by $7.388 million, or 13%, in 2017 compared to 2016. The escalation for 2018 includes the impact of acquisitions on ongoing operating costs and a relatively large increase in group health insurance costs, partially offset by favorable swings of $1.776 million in nonrecurring acquisition costs, $1.000 million in net foreclosed asset costs, and $698,000 in directors deferred compensation expense (related to the drop in BOLI income). Most of the 2017 increase came from higher operating costs associated with branches added via our acquisitions as well as de novo branch expansion. Nonrecurring costs, including those related to acquisitions, are delineated below.
- The Company recorded income tax provisions of $9.907 million, or 25% of pre-tax income in 2018; $13.640 million, or 41% of pre-tax income in 2017; and $8.800 million, or 33% of pre-tax income in 2016. The lower tax rate for 2018 resulted from a reduction in our federal income tax rate starting in 2018. The relatively high tax accrual rate for 2017 over 2016 is primarily the result of the aforementioned $2.710 million deferred tax asset revaluation charge, but also reflects higher taxable income relative to available tax credits.

Financial Condition Summary

The Company’s assets totaled $2.523 billion at December 31, 2018, relative to $2.340 billion at December 31, 2017. Total liabilities were $2.249 billion at the end of 2018 compared to $2.084 billion at the end of 2017, and shareholders’ equity totaled $273 million at December 31, 2018 relative to $256 million at December 31, 2017. The following is a summary of key balance sheet changes during 2018.

- Total assets increased by $182 million, or 8%. The increase resulted primarily from net loan growth.
- Gross loans and leases were up $174 million, or 11%. Loan growth consisted mainly of strong organic growth in real estate loans, largely occurring in commercial real estate and construction loans. Mortgage warehouse loans were down $46 million, or 33%, primarily because a lower utilization rate on mortgage warehouse lines, and commercial and consumer loan balances also declined.
- Deposit balances reflect net growth of $128 million, or 6%. Deposit growth in 2018 includes deposits in our acquired Lompoc branch totaling about $34 million at the reporting date, and the addition of $50 million in wholesale brokered deposits. Core non-maturity deposits fell by close to $8 million, as the Bank’s time deposit

promotion in the fourth quarter resulted in some internal cannibalization of money market deposits in particular, which were down by $48 million, or 28%. Customer time deposits increased by $86 million, or 23%, during 2018, due in large part to the promotion.

- Total capital increased by $17 million, or 7%, ending the year with a balance of $273 million. The increase in capital is due to the addition of net income and capital from stock options exercised, net of dividends paid, and a $4.3 million increase in our accumulated other comprehensive loss.

Results of Operations

As noted above, acquisitions have had a material impact on our operating results in recent periods, including the recognition of nonrecurring acquisition costs as well as higher revenues and ongoing overhead expense. Our results were also materially affected by the reduction in our federal income tax rate, which was enacted at the end of 2017 and became effective at the beginning of 2018. Net income was $29.677 million in 2018, an increase of $10.138 million, or 52%, relative to 2017. Net income also increased by $1.972 million, or 11%, in 2017 compared to 2016. The Company earns income from two primary sources. The first is net interest income, which is interest income generated by earning assets less interest expense on deposits and other borrowed money. The second is noninterest income, which primarily consists of customer service charges and fees but also comes from non-customer sources such as bank-owned life insurance and investment gains. The majority of the Company's noninterest expense is comprised of operating costs that facilitate offering a full range of banking services to our customers.

Net Interest Income and Net Interest Margin

Net interest income was $92.394 million in 2018, compared to $75.701 million in 2017 and $65.182 million in 2016. This equates to increases of 22% in 2018 and 16% in 2017. The level of net interest income we recognize in any given period depends on a combination of factors including the average volume and yield for interest-earning assets, the average volume and cost of interest-bearing liabilities, and the mix of products which comprise the Company's earning assets, deposits, and other interest-bearing liabilities. Net interest income is also impacted by the reversal of interest for loans placed on non-accrual status, and the recovery of interest on loans that had been on non-accrual and were paid off, sold or returned to accrual status.

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

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

	Year Ended December 31,								
	2018			2017			2016		
Assets	Average Balance[1]	Income/ Expense	Average Rate/Yield[2]	Average Balance[1]	Income/ Expense	Average Rate/Yield[2]	Average Balance[1]	Income/ Expense	Average Rate/Yield[2]
Investments:									
Federal funds sold/due from banks	$13,237	$238	1.77 %	$34,832	$356	1.01 %	$11,210	$84	0.74 %
Taxable	422,848	9,548	2.23 %	437,194	8,614	1.94 %	415,902	7,922	1.87 %
Non-taxable	140,300	4,060	3.66 %	133,506	3,711	4.28 %	108,568	3,009	4.26 %
Equity	—	—	—	1,128	16	1.40 %	1,214	40	3.24 %
Total investments	576,385	13,846	2.55 %	606,660	12,697	2.39 %	536,894	11,055	2.32 %
Loans and Leases: [3]									
Real estate	1,350,425	73,006	5.41 %	1,029,224	53,329	5.18 %	827,868	42,107	5.09 %
Agricultural	52,031	2,980	5.73 %	49,335	2,448	4.96 %	48,730	2,143	4.40 %
Commercial	124,809	5,969	4.78 %	120,307	6,252	5.20 %	116,135	5,915	5.09 %
Consumer	9,755	1,251	12.82 %	11,471	1,329	11.59 %	13,789	1,574	11.41 %
Mortgage warehouse	86,030	4,415	5.13 %	105,352	4,690	4.45 %	144,531	5,577	3.86 %
Other	2,682	171	6.38 %	3,220	179	5.56 %	2,187	134	6.13 %
Total loans and leases	1,625,732	87,792	5.40 %	1,318,909	68,227	5.17 %	1,153,240	57,450	4.98 %
Total interest earning assets [4]	2,202,117	101,638	4.66 %	1,925,569	80,924	4.31 %	1,690,134	68,505	4.15 %
Other earning assets	10,514			9,018			8,045		
Non-earning assets	204,316			170,229			146,361		
Total assets	$2,416,947			$2,104,816			$1,844,540		
Liabilities and shareholders' equity									
Interest bearing deposits:									
Demand deposits	$119,432	$364	0.30 %	$135,713	$417	0.31 %	$131,803	$399	0.30 %
NOW	425,596	478	0.11 %	380,626	427	0.11 %	327,961	361	0.11 %
Savings accounts	298,021	314	0.11 %	241,746	258	0.11 %	206,234	229	0.11 %
Money market	149,024	146	0.10 %	136,915	157	0.11 %	109,027	80	0.07 %
CDAR's	—	—	—	32	—	—	3,700	4	0.11 %
Certificates of deposit<$100,000	81,940	614	0.75 %	74,847	292	0.39 %	75,383	236	0.31 %
Certificates of deposit>$100,000	310,880	5,039	1.62 %	274,298	2,211	0.81 %	238,858	865	0.36 %
Brokered deposits	16,822	305	1.81 %	—	—	—	—	—	—
Total interest bearing deposits	1,401,715	7,260	0.52 %	1,244,177	3,762	0.30 %	1,092,966	2,174	0.20 %
Borrowed funds:									
	22	—	—	166	1	0.60 %	822	6	0.73 %

Federal funds purchased									
Repurchase agreements	14,332	57	0.40 %	8,514	34	0.40 %	8,371	33	0.39 %
Short term borrowings	8,967	196	2.19 %	7,074	58	0.82 %	28,333	127	0.45 %
Long term borrowings	—	—	—	—	—	—	306	—	—
TRUPS	34,673	1,731	4.99 %	34,496	1,368	3.97 %	33,403	983	2.94 %
Total borrowed funds	57,994	1,984	3.42 %	50,250	1,461	2.91 %	71,235	1,149	1.61 %
Total interest bearing liabilities	1,459,709	9,244	0.63 %	1,294,427	5,223	0.40 %	1,164,201	3,323	0.29 %
Non-interest bearing demand deposits	665,941			557,686			462,200		
Other liabilities	30,383			31,062			16,521		
Shareholders' equity	260,914			221,641			201,618		
Total liabilities and shareholders' equity	$2,416,947			$2,104,816			$1,844,540		
Interest income/interest earning assets			4.66 %			4.31 %			4.15 %
Interest expense/interest earning assets			0.42 %			0.27 %			0.20 %
Net interest income and margin[5]		$92,394	4.24 %		$75,701	4.04 %		$65,182	3.95 %

[1] Average balances are obtained from the best available daily or monthly data and are net of deferred fees and related direct costs.

[2] Yields and net interest margin have been computed on a tax equivalent basis.

[3] Loans are gross of the allowance for possible loan losses. Net loan fees have been included in the calculation of interest income. Net loan fees and loan acquisition FMV amortization were $818,440, $629,660, and $461,003 for the years ended December 31, 2018, 2017, and 2016 respectively.

[4] Non-accrual loans are slotted by loan type and have been included in total loans for purposes of total interest earning assets.

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

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

Volume & Rate Variances
(dollars in thousands)

	Years Ended December 31,					
	2018 over 2017			2017 over 2016		
	Increase(decrease) due to			Increase(decrease) due to		
Assets:	Volume	Rate	Net	Volume	Rate	Net
Investments:						
Federal funds sold/due from time	$(221)	$103	$(118)	$176	$96	$272
Taxable	(317)	1,251	934	419	273	692
Non-taxable	189	160	349	691	11	702
Equity	(16)	—	(16)	(3)	(21)	(24)
Total investments	(365)	1,514	1,149	1,283	359	1,642
Loans and leases:						
Real estate	16,643	3,034	19,677	10,241	981	11,222
Agricultural	134	398	532	27	278	305
Commercial	234	(517)	(283)	212	125	337
Consumer	(199)	121	(78)	(265)	20	(245)
Mortgage warehouse	(860)	585	(275)	(1,512)	625	(887)
Other	(30)	22	(8)	63	(18)	45
Total loans and leases	15,922	3,643	19,565	8,766	2,011	10,777
Total interest earning assets	$15,557	$5,157	$20,714	$10,049	$2,370	$12,419
Liabilities:						
Interest bearing deposits:						
Demand						
NOW	$(50)	$(3)	$(53)	$12	$6	$18
Savings accounts	50	1	51	58	8	66
Money market	60	(4)	56	39	(10)	29
CDAR's	14	(25)	(11)	20	57	77
Certificates of deposit < $100,000	—	—	—	(4)	—	(4)
Certificates of deposit > $100,000	28	294	322	(2)	58	56
Brokered deposits	295	2,533	2,828	128	1,218	1,346
Total interest bearing deposits	—	305	305	—	—	—
Borrowed funds:	397	3,101	3,498	251	1,337	1,588
Borrowed funds:						
Federal funds purchased	(1)	—	(1)	(5)	—	(5)
Repurchase agreements	23	—	23	1	—	1
Short term borrowings	16	122	138	(95)	26	(69)
Long term borrowings	—	—	—	—	—	—
TRUPS	7	356	363	32	353	385
Total borrowed funds	45	478	523	(67)	379	312

Total interest bearing liabilities	442	3,579	4,021	184	1,716	1,900
Net interest income	$15,115	$1,578	$16,693	$9,865	$654	$10,519

Net interest income in 2018 relative to 2017 reflects a favorable variance of $15.153 million attributable to volume changes, in addition to a favorable rate variance of $1.540 million. The volume variance is due to an increase of $277 million, or 14%, in average interest-earning assets, resulting from the impact of acquisitions and organic growth in loans less a $30 million drop in the average balance of investments. The rate variance is largely the result of a 35 basis point increase in our yield on average earning assets relative to an increase of only 23 basis points in the cost of interest-bearing liabilities. Investment yields have been increasing due to the current rising rate environment, and in response to limited investment portfolio restructuring which took place in the latter part of 2017. Loan yields have risen as a result of the impact of higher short-term index rates on variable-rate loans, and a relatively large volume of new fixed-rate and adjustable-rate loans booked at higher interest rates. Rates paid on non-maturity deposits were about the same for the comparative periods, but the weighted average cost of interest-bearing liabilities went up primarily because of higher rates paid on time deposits (including brokered deposits added in the last half of 2018), overnight borrowings and adjustable-rate trust-preferred securities ("TRUPS"). The Company's variance in net interest income also benefited from the fact that the yield increase on earning assets was applied to a much higher balance than the rate change for interest-bearing liabilities. Nonrecurring interest income totaled $277,000 during 2018 as compared to $736,000 for 2017, for a drop of $459,000. The Company's net interest margin, which is tax-equivalent net interest income as a percentage of average interest-earning assets, was 4.24% for 2018 relative to 4.04% in 2017. Discount accretion on loans from whole-bank acquisitions enhanced our net interest margin by approximately seven basis points in 2018 as compared to five basis points in 2017.

The volume variance calculated for 2017 relative to 2016 was a favorable $9.865 million, due to an increase of $235 million, or 14%, in the average balance of interest-earning assets resulting from the impact of acquisitions and organic growth in loans and investments. There was also a favorable rate variance of $654,000 for 2017 over 2016, again because loan and investment yields increased by more than the cost of interest-bearing liabilities, and because the yield increase on earning assets was applied to a higher balance than the rate change for interest-bearing liabilities. Our net interest margin was up by nine basis points in 2017 relative to 2016.

Provision for Loan and Lease Losses

Credit risk is inherent in the business of making loans. The Company sets aside an allowance for loan and lease losses, a contra-asset account, through periodic charges to earnings which are reflected in the income statement as a provision for loan and lease losses. The Company recorded a loan loss provision of $4.350 million in 2018, as compared to negative loan loss provision of $1.140 million in 2017 and no provision for 2016. The provision for 2018 includes $2.400 million for a large purchased participation loan that was placed on non-accrual status in the third quarter of 2018, and also factors in adjustments to the allowance for loan and lease losses pursuant to our evaluation of overall credit quality, growth in outstanding loan balances, and reserves required for other specifically identified impaired loan balances. The provision reversal in 2017 was made possible by principal recovered on charged-off loan balances, and the zero provision for 2016 was facilitated by the reduction of impaired loan balances, lower loan losses, and tighter underwriting standards for new and renewed loans.

With the loan loss provision recorded in 2018 we were able to maintain our allowance for loan and lease losses at a level that, in Management's judgment, is adequate to absorb probable loan losses related to specifically identified impaired loans as well as probable incurred losses in the remaining loan portfolio. Specifically identifiable and quantifiable loan losses are immediately charged off against the allowance. The Company experienced net loan losses of $3.643 million in 2018, including a $2.400 million loss on the previously-referenced participation loan as the loan was transferred OREO and subsequently sold. The Company recorded net recoveries of $482,000 on charged off balances in 2017, and net loan charge-offs of $722,000 in 2016. Except for the outsized provision required in 2018 for a single loan, our need for reserve replenishment via a loan loss provision has been favorably impacted in recent periods by the following factors: we had net principal recoveries in 2017, which went back into the allowance; all of our acquired loans were booked at their fair values at acquisition, and thus did not initially require a loan loss allowance; most charge-offs were recorded against pre-established reserves, which alleviated what otherwise might have been a need for reserve replenishment; loss rates for most loan types have been declining, thus having a positive

impact on general reserves required for performing loans; and, new loans booked during and since the great recession have been underwritten using tighter credit standards than was the case for many legacy loans.

The Company's policies for monitoring the adequacy of the allowance and determining loan amounts that should be charged off, and other detailed information with regard to changes in the allowance, are discussed in Note 2 to the

consolidated financial statements and below under “Allowance for Loan and Lease Losses.” The process utilized to establish an appropriate allowance for loan and lease losses can result in a high degree of variability in the Company’s loan loss provision, and consequently in our net earnings.

Noninterest Revenue and Operating Expense

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

Non-Interest Income/Expense
(dollars in thousands)

	Year Ended December 31,					
	2018	% of Total	2017	% of Total	2016	% of Total
NON-INTEREST INCOME:						
Service charges on deposit accounts	$12,439	57.69 %	$11,230	51.55 %	$10,151	52.76 %
Checkcard fees	5,878	27.26 %	4,955	22.75 %	4,467	23.22 %
Other service charges and fees	5,219	24.20 %	4,052	18.61 %	3,865	20.09 %
Bank owned life insurance income	591	2.74 %	1,640	7.53 %	994	5.17 %
Gain on sale of securities	2	0.01 %	500	2.30 %	223	1.16 %
Loss on tax credit investment	(2,561)	-11.88 %	(961)	-4.41 %	(944)	-4.91 %
Other	(4)	-0.02 %	363	1.67 %	482	2.51 %
Total non-interest income	21,564	100.00 %	21,779	100.00 %	19,238	100.00 %
As a % of average interest-earning assets		0.98 %		1.13 %		1.14 %
OTHER OPERATING EXPENSES:						
Salaries and employee benefits	36,133	51.61 %	31,506	48.14 %	27,452	47.30 %
Occupancy costs						
Furniture and equipment	2,632	3.76 %	2,674	4.09 %	2,372	4.09 %
Premises	7,663	10.94 %	6,916	10.57 %	5,394	9.29 %
Advertising and promotion costs	2,748	3.92 %	2,514	3.84 %	2,386	4.11 %
Data processing costs	5,015	7.16 %	4,365	6.67 %	3,607	6.21 %
Deposit services costs	5,413	7.73 %	4,426	6.76 %	3,737	6.44 %
Loan services costs						
Loan processing	1,142	1.64 %	1,029	1.57 %	635	1.09 %
Foreclosed assets	(730)	-1.04 %	270	0.41 %	657	1.13 %
Other operating costs						
Telephone and data communications	1,479	2.11 %	1,654	2.53 %	1,552	2.67 %
Postage and mail	997	1.42 %	1,064	1.63 %	997	1.72 %
Other	1,408	2.01 %	1,089	1.67 %	902	1.55 %
Professional services costs						
Legal and accounting	1,932	2.76 %	1,532	2.34 %	1,675	2.89 %
Acquisition costs	449	0.64 %	2,225	3.40 %	2,411	4.15 %
Other professional services costs	1,956	2.79 %	2,266	3.46 %	1,996	3.44 %
Stationery and supply costs	1,387	1.98 %	1,309	2.00 %	1,425	2.45 %
Sundry & tellers	400	0.57 %	602	0.92 %	855	1.47 %
Total other operating expense	$70,024	100.00 %	$65,441	100.00 %	$58,053	100.00 %
As a % of average interest-earning assets		3.18 %		3.40 %		3.43 %
Net non-interest income as a % of average interest-earning assets		-2.20 %		-2.27 %		-2.30 %

Efficiency ratio [1]	60.79	%	65.53	%	67.23	%

[1] Tax Equivalent

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The Company's results reflect a drop of $215,000, or 1%, in total noninterest income in 2018, relative to an increase of $2.541 million, or 13%, in 2017 over 2016. Both 2018 and 2017 include core increases resulting from growth, as discussed in greater detail below, but several items of a nonrecurring nature have also had a significant impact over the past few years. For 2018, nonrecurring noninterest income is comprised primarily of the $1.183 million write-up of our investment in Pacific Coast Bankers Bank ("PCBB") and a $161,000 special dividend received pursuant to our equity investment in the Federal Home Loan Bank of San Francisco ("FHLB"), net of a $915,000 adjustment to accelerate expense amortization associated with tax credit investments (which is netted out of revenue). In 2017, nonrecurring income includes $500,000 in net gains on the sale of investments, $503,000 in life insurance proceeds, and $323,000 in gains from the dissolution of a low-income housing tax credit fund investment, while 2016 includes $223,000 in gains on the sale of investments, $481,000 in life insurance proceeds, and $276,000 in FHLB special dividends. Moreover, while not technically characterized as a nonrecurring item, there were large fluctuations in BOLI income over the last three years, due primarily to varying levels of income on BOLI associated with deferred compensation plans. Total noninterest income was 0.98% of average interest-earning assets in 2018, relative to 1.13% in 2017 and 1.14% in 2016. The ratio has been trending lower due in part to a rising balance of interest-earning assets.

The principal component of the Company's noninterest revenue, service charges on deposit accounts, increased by $1.209 million, or 11%, in 2018 over 2017, and by $1.079 million, or 11%, in 2017 relative to 2016, due to fees earned on a higher number of deposit accounts and additional fees on certain higher-risk commercial accounts. The 2018 variance was also impacted by the reclassification of certain income from other service charges and fees to deposit service charges starting in the third quarter of 2017, with the adjustment boosting service charges on deposits by about $200,000 for 2018 relative to 2017. The Company's ratio of service charge income to average transaction account balances was 1.0% in 2018 and 2017, down slightly from 1.1% in 2016.

The line item immediately following service charges on deposits is checkcard fees, consisting of interchange fees from our customers' use of debit cards for electronic funds transactions. This category increased by $923,000, or 19%, in 2018 over 2017, and by $488,000, or 11%, in 2017 over 2016 as a result of growth in our deposit account base, including the addition of accounts pursuant to acquisitions. Other service charges and fees, which also constitute a relatively large portion of noninterest income, increased by $1.167 million, or 29%, in 2018 over 2017, and by $187,000, or 5%, in 2017 over 2016. The increase for 2018 includes the impact of the $1.183 million write-up of our PCBB investment and the $161,000 special dividend from the FHLB in 2018, offset by $200,000 due to the income reclassification noted in the previous paragraph. The increase in this category in 2017 reflects a stronger volume of fee-generating activities.

BOLI income fell by $1.049 million, or 64%, in 2018 over 2017 but increased by $646,000, or 65%, in 2017 over 2016. BOLI income is derived from two types of policies owned by the Company, namely "separate account" and "general account" life insurance, and the year over year variances are due in large part to fluctuations in income on separate account BOLI. The Company had $6.6 million invested in separate account BOLI at December 31, 2018, which produces income that helps offset expense accruals for deferred compensation accounts the Company maintains on behalf of certain directors and senior officers. Those accounts have returns pegged to participant-directed investment allocations that can include equity, bond, or real estate indices, and are thus subject to gains or losses which often contribute to significant fluctuations in income (and associated expense accruals). Losses on separate account BOLI totaled $381,000 in 2018, relative to gains of $690,000 in 2017 and $151,000 in 2016. This resulted in a negative variance of $1.071 million in 2018 over 2017, and an increase of $539,000 in 2017 over 2016. As noted, gains and losses on separate account BOLI are related to expense accruals or reversals associated with participant gains and losses on deferred compensation balances, thus their net impact on taxable income tends to be minimal. The Company's books also reflect a net cash surrender value of $41.6 million for general account BOLI at year-end 2018. General account BOLI produces income that is used to help offset expenses associated with executive salary continuation plans, director retirement plans and other employee benefits. Interest credit rates on general account BOLI do not change frequently so the income has typically been fairly consistent. While rate reductions and an increase in the cost of insurance for certain policies created downward pressure on general account BOLI income over

the past few years, the average income crediting rate improved in 2017 due to the termination of a high-cost policy in late 2016. Furthermore, the Ojai acquisition included over $2 million in BOLI, thus income on general account BOLI reflects small increases for 2018 and 2017.

The Company realized only $2,000 in gains on investments in 2018, but as previously referenced we realized net gains on the sale of investments of $500,000 in 2017 and $223,000 in 2016. The next line item reflects pass-through

expenses associated with our investments in low-income housing tax credit funds and other limited partnerships. Those expenses, which are netted out of revenue, increased by $1.600 million, or 166%, in 2018 over 2017, and by $17,000, or 2%, in 2017 relative to 2016. The largest contribution to the unfavorable variance in 2018 over 2017 came from a $915,000 adjustment to accelerate expense amortization on our tax credit investments, to ensure that the book value of each investment does not exceed its projected remaining tax benefits. However, variances in both 2018 and 2017 were also impacted by expense amortization for newer investments and a gain of $323,000 realized in 2017 from the dissolution of one of our earliest tax credit investment funds.

Other noninterest income includes gains and losses on the disposition of assets other than OREO, rent on bank-owned property other than OREO, life insurance proceeds, loan servicing income (net of amortization expense on our servicing asset), and other miscellaneous income. There was a drop of $367,000 in other noninterest income in 2018 relative to 2017, due to nonrecurring life insurance proceeds totaling $503,000 recorded in 2017. The category also declined by $119,000 in 2017 relative to 2016, due to the disposition of certain fixed assets at a loss in 2017. As noted above, life insurance proceeds totaled $503,000 in 2017 relative to $481,000 in 2016, for an immaterial difference.

Total operating expense, or noninterest expense, increased by $4.583 million, or 7%, in 2018 over 2017, and by $7.388 million, or 13%, in 2017 relative to 2016. The increase for 2018 is due primarily to a full year of operating costs associated with the Ojai whole-bank acquisition and a partial year of costs for the Lompoc branch acquisition, offset in part by favorable swings of $1.000 million in net foreclosed asset costs and $698,000 in directors deferred compensation expense (related to the drop in BOLI income). The increase for 2017 is also comprised in large part of ongoing operating costs incidental to our acquisitions and de novo branch expansion. Noninterest expense includes the following items of a nonrecurring nature: for 2018, net foreclosed asset costs of negative $730,000 due to gains on the sale of OREO, and acquisition costs of $449,000; for 2017, acquisition costs of $2.225 million, lending-related costs totaling about $300,000, and net OREO expense of $270,000; and, for 2016, acquisition costs of $2.411 million, net OREO expense of $657,000, and a nonrecurring expense reversal of $173,000 in director retirement plan accruals subsequent to the death of a former director and the payment of split-dollar life insurance proceeds to his beneficiary. Noninterest expense was 3.18% of average earning assets in 2018, relative to 3.40% in 2017 and 3.43% for 2016. The downward trend is due in part to growth in average earning assets, and the ratios were also impacted by OREO gains in 2018 and higher acquisition costs in 2017 and 2016.

The largest component of operating expense, salaries and employee benefits, was up by $4.627 million, or 15%, in 2018 over 2017 and $4.054 million, or 15%, in 2017 over 2016. Personnel costs increased in 2018 due to a full year of costs for employees retained subsequent to our acquisitions in 2017 and offices opened in 2017, staffing costs for the Lompoc branch acquired in 2018, salary adjustments in the normal course of business, and an increase of $593,000, or 23%, in group health insurance costs. The increase for 2017 is due mainly to expenses for employees retained subsequent to our acquisitions, staffing costs for branch offices that commenced operations in 2017, and higher costs for temporary employees and overtime related to the Ojai whole-bank and Woodlake branch acquisitions and system conversions, but also includes salary adjustments in the normal course of business, costs for non-acquisition related staff additions, a relatively large increase in group health insurance costs, and higher equity incentive compensation expense related to stock options. Components of compensation expense that can experience significant variability and are typically difficult to predict include salaries associated with successful loan originations, which are accounted for in accordance with Financial Accounting Standards Board (“FASB”) guidelines on the recognition and measurement of non-refundable fees and origination costs for lending activities, and accruals associated with employee deferred compensation plans. Loan origination salaries that were deferred from current expense for recognition over the life of related loans totaled $4.173 million in 2018, $3.854 million for 2017, and $3.430 million for 2016, with the fluctuations due to variability in successful organic loan origination activity. Employee deferred compensation expense accruals totaled only $7,000 for 2018, relative to $217,000 in 2017 and $141,000 in 2016. As noted above in our discussion of BOLI income, employee deferred compensation plan accruals are related to separate account BOLI income and losses, as are directors deferred compensation accruals that are included in “other professional services,” and the net income impact of all income/expense accruals related to

deferred compensation is usually minimal. Salaries and benefits were 51.61% of total operating expense in 2018, relative to 48.14% in 2017 and 47.30% in 2016. The number of full-time equivalent staff employed by the Company totaled 541 at the end of 2018, 556 at the end of 2017, and 479 at the end of 2016. The reduction in 2018 came from efficiency initiatives implemented toward the end of the year and more open positions, partially offset by staff additions related to the Lompoc branch acquisition. The increase in 2017 over 2016 is due to the addition of former Ojai Community Bank employees and

Woodlake branch staff, personnel for de novo branches opened in 2017, and certain back office additions deemed necessary to ensure a continued high level of customer service.

Total rent and occupancy expense, including furniture and equipment costs, increased by $705,000, or 7%, in 2018 over 2017, compared to $1.824 million, or 23%, in 2017 over 2016. The increase for 2018 includes the impact of the acquisition and de novo branch offices, and was also due in part to an accrual adjustment that inflated rent expense in 2017. The increase in 2017 was primarily the result of expenses associated with locations added during the year, including certain non-recurring start-up costs associated with outfitting new branches, but it also includes inflationary increases related to other locations and the impact of expense accrual adjustments in 2017.

Advertising and promotion costs were up by $234,000, or 9%, in 2018 over 2017 and $128,000, or 5%, in 2017 over 2016. The increases are mainly the result of marketing efforts targeting our expanded geography, and other promotional expenses associated with opening new branches. Data processing costs increased by $650,000, or 15%, in 2018 over 2017 and $758,000, or 21%, in 2017 compared to 2016. The increase in 2018 is primarily from additional core processing costs and other software costs associated with Bank expansion. The increase in 2017 is from ongoing expenses related to our acquisitions and new branches, but also includes costs associated with an online lending platform that was implemented at the beginning of 2017. Deposit services costs also increased by $987,000, or 22%, in 2018 over 2017 and $689,000, or 18%, in 2017 over 2016. As with data processing costs, much of the increase in deposit costs is the result of ongoing expenses associated with our acquisitions, including operational costs and amortization expense on our core deposit intangible, as well as expenses for other new offices. Deposit costs were further impacted by increases in debit card processing costs due to higher activity levels.

Loan services costs are comprised of loan processing costs, and net costs associated with foreclosed assets. Loan processing costs, which include expenses for property appraisals and inspections, loan collections, demand and foreclosure activities, loan servicing, loan sales, and other miscellaneous lending costs, increased by $113,000, or 11%, in 2018 over 2017 and $394,000, or 62%, in 2017 relative to 2016. The increase in 2018 resulted from a higher level of appraisal, inspection and credit reporting costs incidental to more robust lending activity as well as a $90,000 increase in our reserve for unfunded commitments, but the variance was also favorably impacted by $300,000 in nonrecurring lending costs in 2017, as noted above. The increase in 2017 over 2016 is due primarily to those nonrecurring lending costs, but it also includes costs related to an increase in lending activity. Foreclosed assets costs are comprised of write-downs taken subsequent to reappraisals, OREO operating expense (including property taxes), and losses on the sale of foreclosed assets, net of rental income on OREO properties and gains on the sale of foreclosed assets. Those costs reflect reductions of $1.000 million in 2018 relative to 2017, and $387,000 in 2017 over 2016. The drop for 2018 resulted mainly from a $1.367 million increase in gains on OREO sales, net of a $343,000 increase in OREO write-downs. The decline in 2017 came primarily in lower OREO write-downs relative to 2016.

The “other operating costs” category includes telecommunications expense, postage, and other miscellaneous costs. Telecommunications expense was $175,000 lower in 2018 than in 2017, an 11% decline due to focused expense reduction efforts, but costs increased by $102,000, or 7%, in 2017 relative to 2016 due mainly to expenses associated with branch expansion. Postage expense also dropped by $67,000, or 6%, in 2018 relative to 2017 due to efficiency initiatives implemented in 2018, but increased by $67,000, or 7%, in 2017 over 2016 due mainly to statements and disclosures mailed to an expanding customer base. The “Other” category under other operating costs was up by $319,000, or 29%, in 2018 over 2017 due to higher consulting and training costs, and by $187,000, or 21%, in 2017 over 2016 due primarily to higher travel costs, which rose in connection with our acquisitions and conversions, de novo branches, and increased frequency of offsite meetings.

Legal and accounting costs increased by $400,000, or 26%, in 2018 over 2017, primarily as a result of higher audit and tax costs and higher legal costs associated with collections. The increase in audit and tax costs resulted in part from an expense accrual reversal of $140,000 in 2017, resulting from an accrual carried over from the previous year that was ultimately not needed. Legal and accounting costs declined $143,000, or 9%, in 2017 relative to 2016, since

the accrual adjustment in 2017 and lower collections-related legal costs offset increases in other areas. Acquisition costs, or one-time expenses directly attributable to our whole-bank and branch acquisitions, totaled $449,000 in 2018, relative to $2.225 million in 2017 and $2.411 million in 2016. Acquisition costs are comprised primarily of termination fees for core processing contracts and certain other contracts, software conversion costs, financial advisor fees, legal costs, severance and retention amounts paid to employees of the acquired institutions, and the write-off of furniture, fixtures and equipment that were not utilized by the Company.

Other professional services costs include FDIC assessments and other regulatory expenses, directors' costs, and certain insurance costs among other things. This category declined by $310,000, or 14%, in 2018 relative to 2017, but increased by $270,000, or 14%, in 2017 over 2016. The drop in 2018 stems from a favorable swing of $698,000 in director's deferred compensation expense, which more than offset higher FDIC costs and corporate insurance premiums. The increase in 2017 includes higher director's deferred compensation expense, an increase stemming from a nonrecurring reversal of $173,000 in director retirement plan accruals in 2016, and higher stock option expense, partially offset by lower regulatory assessments. As with deferred compensation accruals for employees, directors' deferred compensation expense is related to separate account BOLI income and losses, and the net income impact of all income/expense accruals related to deferred compensation is usually minimal. Directors' deferred compensation expense reflects an expense reversal of $100,000 in 2018 resulting from losses on deferred compensation plans, as compared to expense accruals totaling $598,000 in 2017 and $173,000 in 2016.

Stationery and supply costs increased by $78,000, or 6%, in 2018 over 2017, but fell by $116,000, or 8%, in 2017 compared to 2016. The increase in 2018 reflects expenses associated with Bank expansion. Stationery and supply costs for 2017 also reflect additional expenses for a larger number of branches, but the variance relative to 2016 was favorably impacted by costs associated with the issuance of new debit cards incorporating EMV technology in 2016. Sundry and teller costs reflect reductions of $202,000, or 34% in 2018 as compared to 2017, and $253,000, or 30%, in 2017 relative to 2016 due to reduced debit card losses and lower operations-related losses.

The Company's tax-equivalent overhead efficiency ratio was 60.79% in 2018, relative to 65.52% in 2017 and 67.23% in 2016. The overhead efficiency ratio represents total noninterest expense divided by the sum of fully tax-equivalent net interest and noninterest income, with the provision for loan losses and investment gains/losses excluded from the equation. The ratio was relatively low in 2018 due in part to nonrecurring OREO gains, and it was higher in 2017 and 2016 due in part to non-recurring acquisition costs incurred in those periods.

Income Taxes

Our income tax provision was $9.907 million, or 25% of pre-tax income in 2018, relative to provisions of $13.640 million, or 41% of pre-tax income in 2017 and $8.800 million, or 33% of pre-tax income in 2016. The tax accrual rate dropped in 2018 because of a lower federal income tax rate. The tax accrual rate for 2017 was higher than in 2016 primarily because of the $2.710 million deferred tax asset revaluation charge, but it also reflects higher taxable income relative to available tax credits.

The Company sets aside a provision for income taxes on a monthly basis. The amount of that provision is determined by first applying the Company's statutory income tax rates to estimated taxable income, which is pre-tax book income adjusted for permanent differences, and then subtracting available tax credits. Permanent differences include but are not limited to tax-exempt interest income, BOLI income, and certain book expenses that are not allowed as tax deductions. The Company's investments in state, county and municipal bonds provided $4.060 million in federal tax-exempt income in 2018, $3.711 million in 2017, and $3.009 million in 2016. Moreover, in addition to life insurance proceeds of $503,000 in 2017 and $481,000 in 2016, net increases in the cash surrender value of bank-owned life insurance added $591,000 to tax-exempt income in 2018, $1.640 million in 2017 and $994,000 in 2016.

Our tax credits consist primarily of those generated by investments in low-income housing tax credit funds, and California state employment tax credits. We had a total of $5.9 million invested in low-income housing tax credit funds as of December 31, 2018, which are included in other assets rather than in our investment portfolio. Those investments have generated substantial tax credits over the past few years, with about $632,000 in credits available for the 2018 tax year, $711,000 in tax credits utilized in 2017, and $686,000 in tax credits utilized in 2016. The credits are dependent upon the occupancy level of the housing projects and income of the tenants, and cannot be projected with certainty. Furthermore, our capacity to utilize them will continue to depend on our ability to generate sufficient pre-tax income. We plan to invest in additional tax credit funds in the future, but if the economics of such transactions

do not justify continued investments then the level of low-income housing tax credits will taper off in future years until they are substantially utilized by the end of 2028. That means that even if taxable income stayed at the same level through 2028, our tax accrual rate would gradually increase.

Financial Condition

Assets totaled $2.523 billion at the end of 2018, reflecting an increase of $182 million, or 8%, for the year due primarily to an increase of $174 million, or 11%, in gross loan balances. Deposits were up $128 million, or 6%, while non-deposit borrowings, including junior subordinated debentures, were increased by $43 million, or 66%. Total capital increased by $17 million, or 7%. The major components of the Company's balance sheet are individually analyzed below, along with information on off-balance sheet activities and exposure.

Loan and Lease Portfolio

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

The Selected Financial Data table in Item 6 above reflects the amount of loans and leases outstanding at December 31st for each year from 2018 back to 2014, net of deferred fees and origination costs and the allowance for loan and lease losses. The Loan and Lease Distribution table that follows sets forth by loan type the Company's gross loans and leases outstanding, and the percentage distribution in each category at the dates indicated. The balances for each loan type include nonperforming loans, if any, but do not reflect any deferred or unamortized loan origination, extension, or commitment fees, or deferred loan origination costs. Although not reflected in the loan totals below and not currently comprising a material part of our lending activities, the Company also occasionally originates and sells, or participates out portions of, loans to non-affiliated investors.

Loan and Lease Distribution
(dollars in thousands)

	As of December 31,				
	2018	2017	2016	2015	2014
Real estate:					
1-4 family residential construction	$105,676	$74,256	$32,417	$14,941	$5,858
Other construction/land	109,023	58,779	40,650	37,359	19,908
1-4 family - closed-end	236,825	204,766	137,143	137,356	114,259
Equity lines	56,320	62,590	43,443	44,233	49,717
Multi-family residential	54,877	42,930	31,631	27,222	18,718
Commercial real estate - owner occupied	301,324	263,447	253,535	218,708	218,654
Commercial real estate - non-owner occupied	438,344	379,432	244,198	165,107	132,077
Farmland	151,541	140,516	134,480	133,182	145,039
Total real estate	1,453,930	1,226,716	917,497	778,108	704,230
Agricultural	49,103	46,796	46,229	46,237	27,746
Commercial and industrial	128,220	135,662	123,595	113,207	113,771
Mortgage warehouse lines	91,813	138,020	163,045	180,355	106,021
Consumer loans	8,862	10,626	12,165	14,949	18,885
Total loans and leases	$1,731,928	$1,557,820	$1,262,531	$1,132,856	$970,653
Percentage of Total Loans and Leases					
Real estate:					
1-4 family residential construction	6.10 %	4.77 %	2.57 %	1.32 %	0.60 %
Other construction/land	6.29 %	3.77 %	3.22 %	3.30 %	2.05 %
1-4 family - closed-end	13.67 %	13.14 %	10.86 %	12.12 %	11.77 %
Equity lines	3.25 %	4.02 %	3.44 %	3.90 %	5.12 %
Multi-family residential	3.17 %	2.76 %	2.51 %	2.40 %	1.93 %
Commercial real estate - owner occupied	17.40 %	16.91 %	20.08 %	19.31 %	22.53 %
Commercial real estate - non-owner occupied	25.32 %	24.36 %	19.34 %	14.57 %	13.61 %
Farmland	8.75 %	9.02 %	10.65 %	11.76 %	14.94 %
Total real estate	83.95 %	78.75 %	72.67 %	68.69 %	72.55 %
Agricultural	2.84 %	3.00 %	3.66 %	4.08 %	2.86 %
Commercial and industrial	7.40 %	8.71 %	9.79 %	9.99 %	11.72 %
Mortgage warehouse lines	5.30 %	8.86 %	12.91 %	15.92 %	10.92 %
Consumer loans	0.51 %	0.68 %	0.96 %	1.32 %	1.95 %
	100.00 %	100.00 %	100.00 %	100.00 %	100.00 %

The Company has experienced net growth in loan and lease balances in each of the last five years, despite fluctuations caused by variability in outstanding balances on mortgage warehouse lines, reductions associated with the resolution of impaired loans, weak loan demand in some years, tightened underwriting standards, and intense competition. This growth is due in part to acquisitions, including Santa Clara Valley Bank in 2014, Coast National Bank in 2016 and Ojai Community Bank in 2017, as well as whole loan purchases and participations. Organic loan growth has also been relatively robust in recent periods, particularly with regard to commercial real estate and construction loans.

For 2018, gross loans were up by $174 million, or 11%, due to strong growth in real estate loans net of a $46 million reduction in outstanding balances on mortgage warehouse lines. Total real estate loans increased by $227 million, or 19%, primarily from organic growth, but the increase also includes the first quarter bulk purchase of single-family

mortgage loans which had a balance of $11 million at the time of purchase. Agricultural production loans were also up $2 million, or 5%. Commercial loans, however, reflect a net drop of $7 million, or 5%, and outstanding balances on mortgage warehouse lines declined by $46 million, or 33%, as the utilization rate on those lines dropped to 23% at December 31, 2018 from 34% at December 31, 2017. Mortgage lending activity is highly correlated with changes in interest rates and refinancing activity and has historically been subject to significant fluctuations, so no assurance can be provided with regard to our ability to maintain or grow mortgage warehouse balances. Consumer loans also fell by $2 million, or 17%, during 2018.

Management remains focused on organic loan growth, which combined with strong economic activity in some of our markets led to record levels for our pipeline of loans in process of approval in recent periods. However, no assurance can be provided with regard to future net growth in aggregate loan balances since we are still experiencing occasional surges in prepayments in addition to significant fluctuations in mortgage warehouse lending, and the market for top-quality loans remains extremely competitive.

Loan and Lease Maturities

The following table shows the maturity distribution for total loans and leases outstanding as of December 31, 2018, including non-accruing loans, grouped by remaining scheduled principal payments:

Loans and Lease Maturity
(dollars in thousands)

	As of December 31, 2018						
	Three months or less	Three months to twelve months	One to five years	Over five years	Total	Floating rate: due after one year	Fixed rate: due after one year
Real estate	$85,113	$ 97,893	$131,018	$1,139,906	$1,453,930	$956,625	$314,299
Agricultural	5,183	35,124	5,957	2,839	49,103	7,619	1,177
Commercial and industrial	9,798	31,655	41,744	45,023	128,220	34,990	51,777
Mortgage warehouse lines	8,173	61,369	22,271	—	91,813	—	22,271
Consumer loans	955	674	3,659	3,574	8,862	1,140	6,093
Total	$109,222	$ 226,715	$204,649	$1,191,342	$1,731,928	$ 1,000,374	$395,617

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

Off-Balance Sheet Arrangements

The Company maintains commitments to extend credit in the normal course of business, as long as there are no violations of conditions established in the outstanding contractual arrangements. Unused commitments to extend credit totaled $782 million at December 31, 2018 and $692 million at December 31, 2017, although it is not likely that all of those commitments will ultimately be drawn down. The relatively large increase during 2018 is due in part to a higher level of construction loans, which fund incrementally rather than immediately at booking, and lower utilization on mortgage warehouse lines. Unused commitments represented approximately 45% of gross loans outstanding at December 31, 2018 and 44% at December 31, 2017. The Company also had undrawn letters of credit issued to customers totaling $9 million at December 31, 2018 and 2017. Off-balance sheet obligations pose potential credit risk to the Company, and a $384,000 reserve for unfunded commitments is reflected as a liability in our consolidated

balance sheet at December 31, 2018, up from $334,000 at December 31, 2017. The effect on the Company's revenues, expenses, cash flows and liquidity from the unused portion of the commitments to provide credit cannot be reasonably predicted because there is no guarantee that the lines of credit will ever be used. However, the "Liquidity" section in this Form 10-K outlines resources available to draw upon should we be required to fund a significant portion of unused commitments.

In addition to unused commitments to provide credit, the Company is utilizing a $95 million letter of credit issued by the Federal Home Loan Bank on the Company's behalf as security for certain deposits and to facilitate certain credit arrangements with the Company's customers. That letter of credit is backed by loans which are pledged to the FHLB by the Company. For more information regarding the Company's off-balance sheet arrangements, see Note 12 to the consolidated financial statements in Item 8 herein.

Contractual Obligations

At the end of 2018, the Company had contractual obligations for the following payments, by type and period due:

Contractual Obligations
(dollars in thousands)

	Payments Due by Period				
	Total	Less Than 1 Year	1-3 Years	3-5 Years	More Than 5 Years
Subordinated debentures	$34,767	$ —	$ —	$ —	$ 34,767
Operating leases	13,003	2,190	5,755	2,452	2,606
Other long-term obligations	3,773	842	1,067	31	1,833
Total	$51,543	$ 3,032	$ 6,822	$ 2,483	$ 39,206

Nonperforming Assets

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

The following table presents comparative data for the Company's NPAs and performing TDRs as of the dates noted:

Nonperforming Assets and Performing TDRs
(dollars in thousands)

	As of December 31,				
	2018	2017	2016	2015	2014
Real estate:					
Other construction/land	$82	$77	$558	$457	$3,547
1-4 family - closed-end	799	871	963	2,298	3,042
Equity lines	408	922	1,926	1,770	1,049
Multi-family residential	—	—	—	630	171
Commercial real estate - owner occupied	605	236	1,572	2,325	3,417
Commercial real estate - non-owner occupied	49	123	67	262	7,754
Farmland	1,642	293	39	610	51
TOTAL REAL ESTATE	3,585	2,522	5,125	8,352	19,031
Agricultural	—	—	89	—	—
Commercial and industrial	1,425	1,301	692	710	821
Consumer loans	146	140	459	572	826
TOTAL NONPERFORMING LOANS [(1)]	$5,156	$3,963	$6,365	$9,634	$20,678
Foreclosed assets	1,082	5,481	2,225	3,193	3,991
Total nonperforming assets	$6,238	$9,444	$8,590	$12,827	$24,669
Performing TDRs [(1)]	$11,005	$12,413	$14,182	$12,431	$12,359
Nonperforming loans as a % of total gross loans and leases	0.30 %	0.25 %	0.50 %	0.85 %	2.13 %
Nonperforming assets as a % of total gross loans and leases and foreclosed assets	0.36 %	0.60 %	0.68 %	1.13 %	2.53 %

(1) Performing TDRs are not included in nonperforming loans above, nor are they included in the numerators used to calculate the ratios disclosed in this table.

NPAs totaled $6.2 million, or 0.36% of gross loans and leases plus foreclosed assets at the end of 2018, down from $9.4 million, or 0.60% of gross loans and leases plus foreclosed assets at the end of 2017. NPAs were reduced by $3.2 million, or 34%, during 2018, and the decline is even more dramatic when looking further back in time. This reduction has occurred in response to better economic conditions and our continuous efforts to improve credit quality. Not reflected in the period-end numbers is the addition of a $10 million purchased participation loan to nonperforming loans in August 2018. That loan was written down by a total of $2.4 million, and was ultimately transferred to OREO and sold in the fourth quarter of 2018.

The contraction in NPAs in 2018 includes a drop in foreclosed assets of $4.4 million, but nonperforming loans increased by $1.2 million, or 30%, ending the year with a balance of $5.2 million. Nonperforming loans secured by real estate comprised $3.6 million of total nonperforming loans at December 31, 2018, up by $1.1 million, or 42%, since December 31, 2017. The balance of nonperforming commercial loans also increased by $124,000, or 10%, during 2018, ending the period at $1.4 million. We have no reason to believe that there will be additional material increases in nonperforming real estate or commercial loans in the near term, but no assurance can be provided in that regard. Nonperforming loan balances at December 31, 2018 include $1.4 million in TDRs and other loans that were paying as agreed, but which met the technical definition of nonperforming and were classified as such. We also had $11.0 million in loans classified as performing TDRs for which we were still accruing interest at December 31, 2018, a drop of $1.4 million, or 11%, relative to December 31, 2017. Notes 2 and 4 to the consolidated financial statements provide a more comprehensive disclosure of TDR balances and activity within recent periods.

The balance of foreclosed assets had a carrying value of $1.1 million at December 31, 2018, comprised of 11 properties classified as OREO. At the end of 2017 foreclosed assets totaled $5.5 million, consisting of 13 properties classified as OREO and three mobile homes. The $4.4 million reduction in OREO is due in large part to the sale of a $3.1 million property that was in OREO at Ojai Community Bank prior to the acquisition, but also includes OREO write-

downs toaling $439,000 and the sale of other properties. All foreclosed assets are periodically evaluated and written down to their fair value less expected disposition costs, if lower than the then-current carrying value. An action plan is in place for each of our non-accruing loans and foreclosed assets and they are all being actively managed. Collection efforts are continuously pursued for all nonperforming loans, but no assurance can be provided that they will be resolved in a timely manner or that nonperforming balances will not increase.

Allowance for Loan and Lease Losses

The allowance for loan and lease losses, a contra-asset, is established through a provision for loan and lease losses. It is maintained at a level that is considered adequate to absorb probable losses on specifically identified impaired loans, as well as probable incurred losses inherent in the remaining loan portfolio. Specifically identifiable and quantifiable losses are immediately charged off against the allowance; recoveries are generally recorded only when sufficient cash payments are received subsequent to the charge off. Note 2 to the consolidated financial statements provides a more comprehensive discussion of the accounting guidance we conform to and the methodology we use to determine an appropriate allowance for loan and lease losses.

The Company’s allowance for loan and lease losses was $9.8 million, or 0.56% of gross loans at December 31, 2018, relative to $9.0 million, or 0.58% of gross loans at December 31, 2017. The increase in the allowance resulted from the addition of a $4.4 million loan loss provision in 2018, less $3.6 million in net loan charge-offs. Reserves were established for losses inherent in incremental loan balances and unanticipated charge-offs in 2018, including $2.4 million related to the large purchased participation loan already discussed. The net increase in the allowance might have been even larger if not for the following circumstances: many charge-offs were recorded against pre-established reserves, which alleviated what otherwise might have been a need for reserve replenishment; all acquired loans were booked at their fair values, and thus did not initially require a loan loss allowance; loan loss rates have been declining, having a positive impact on general reserves established for performing loans; and, new loans booked during and since the great recession have been underwritten using tighter credit standards than was the case for many legacy loans. The ratio of the allowance to nonperforming loans was 189.10% at December 31, 2018, relative to 228.19% at December 31, 2017 and 152.41% at December 31, 2016. A separate allowance of $384,000 for potential losses inherent in unused commitments is included in other liabilities at December 31, 2018.

The table that follows summarizes the activity in the allowance for loan and lease losses for the periods indicated:

Allowance for Loan and Lease Losses
(dollars in thousands)

	As of and for the years ended December 31,				
Balances:	2018	2017	2016	2015	2014
Average gross loans and leases outstanding during period	$1,625,732	$1,318,909	$1,153,240	$1,027,983	$1,027,983
Gross loans and leases held for investment	$1,731,928	$1,557,820	$1,262,531	$1,132,856	$970,653
Allowance for Loan and Lease Losses:					
Balance at beginning of period	$9,043	$9,701	$10,423	$11,248	$11,677
Provision charged to expense	4,350	(1,140)	—	—	350
Charge-offs					
Real estate:					
1-4 family residential construction	—	—	—	—	—
Other construction/land	4	—	144	73	135
1-4 family - closed-end	5	7	97	224	431
Equity lines	125	58	94	92	828
Multi-family residential	—	—	50	—	—
Commercial real estate - owner occupied	—	36	108	318	171
Commercial real estate - non-owner occupied	2,341	—	469	—	45
Farmland	—	—	—	—	19
TOTAL REAL ESTATE	2,475	101	962	707	1,629
Agricultural	—	154	—	—	124
Commercial and industrial	608	669	344	395	625
Mortgage warehouse lines	—	—	—	—	—
Consumer loans	2,225	2,161	1,905	1,738	1,837
Total	5,308	3,085	3,211	2,840	4,215
Recoveries					
Real estate:					
1-4 family residential construction	—	—	—	—	38
Other construction/land	—	5	467	117	702
1-4 family - closed-end	10	1,959	15	93	317
Equity lines	134	32	17	189	273
Multi-family residential	—	—	—	—	—
Commercial real estate - owner occupied	230	38	35	106	504
Commercial real estate - non-owner occupied	—	201	449	246	79
Farmland	—	—	—	—	—
TOTAL REAL ESTATE	374	2,235	983	751	1,913
Agricultural	22	5	14	81	6
Commercial and industrial	148	310	477	225	801
Mortgage warehouse lines	—	—	—	—	—
Consumer loans	1,121	1,017	1,015	958	716
Total	1,665	3,567	2,489	2,015	3,436
Net loan (recoveries) charge offs	3,643	(482)	722	825	779
Balance	$9,750	$9,043	$9,701	$10,423	$11,248

RATIOS										
Net loan and lease charge-offs to average loans and leases	0.22	%	-0.04	%	0.06	%	0.08	%	0.08	%
Allowance for loan and lease losses to gross loans and leases at end of period	0.56	%	0.58	%	0.77	%	0.92	%	1.16	%
Allowance for loan losses to non-performing loans	189.10	%	228.19	%	152.41	%	108.19	%	54.40	%
Net loan and lease charge-offs to allowance for loan losses at end of period	37.36	%	-5.33	%	7.44	%	7.92	%	6.93	%
Net loan charge-offs to provision for loan and lease losses	83.75	%	42.28	%	—		—		222.57	%

As shown in the table above, the Company recorded a loan loss provision of $4.350 million in 2018, relative to a negative loan loss provision of $1.140 million in 2017 and no provision in 2016. As previously noted, there were net charged off balances totaling $3.643 million in 2018, as compared to $482,000 in net recoveries on previously charged-off balances in 2017 and net loan losses of $722,000 in 2016. Any shortfall in the allowance identified pursuant to our analysis of remaining probable losses is covered by quarter-end. Our allowance for probable losses on specifically identified impaired loans was increased by $854,000, or 74%, during 2018, due to reserves required

for additions to nonperforming loans. The allowance for probable losses inherent in non-impaired loans was down by $147,000, or 2%, as a result of continued credit quality improvement. The "Provision for Loan and Lease Losses" section above includes additional details on our provision and its relationship to actual charge-offs.

Provided below is a summary of the allocation of the allowance for loan and lease losses for specific loan categories at the dates indicated. The allocation presented should not be viewed as an indication that charges to the allowance will be incurred in these amounts or proportions, or that the portion of the allowance allocated to a particular loan category represents the total amount available for charge-offs that may occur within that category.

Allocation of Allowance for Loan and Lease Losses
(dollars in thousands)

	As of December 31,														
	2018			2017			2016			2015			2014		
	Amount	%Total [1] Loans		Amount	%Total [1] Loans		Amount	%Total [1] Loans		Amount	%Total [1] Loans		Amount	%Total [1] Loans	
Real Estate	$5,831	83.95	%	$4,786	78.75	%	$3,548	72.67	%	$4,783	68.69	%	$6,243	72.55	%
Agricultural	256	2.84	%	208	3.00	%	209	3.66	%	722	4.08	%	986	2.86	%
Commercial and industrial [2]	2,394	12.70	%	2,772	17.57	%	4,279	22.71	%	2,533	25.91	%	1,944	22.64	%
Consumer loans	1,239	0.51	%	1,231	0.68	%	1,208	0.96	%	1,263	1.32	%	1,765	1.95	%
Unallocated	30	—		46	—		457	—		1,122	—		310	—	
Total	$9,750	100.00	%	$9,043	100.00	%	$9,701	100.00	%	$10,423	100.00	%	$11,248	100.00	%

[1] Represents percentage of loans in category to total loans

[2] Includes mortgage warehouse lines

The Company's allowance for loan and lease losses at December 31, 2018 represents Management's best estimate of probable losses in the loan portfolio as of that date, but no assurance can be given that the Company will not experience substantial losses relative to the size of the allowance. Furthermore, fluctuations in credit quality, changes in economic conditions, updated accounting or regulatory requirements, and/or other factors could induce us to augment or reduce the allowance.

Investments

The Company's investments can at any given time consist of debt securities and marketable equity securities (together, the "investment portfolio"), investments in the time deposits of other banks, surplus interest-earning balances in our Federal Reserve Bank ("FRB") account, and overnight fed funds sold. Surplus FRB balances and fed funds sold to correspondent banks typically represent the temporary investment of excess liquidity. The Company's investments serve several purposes: 1) they provide liquidity to even out cash flows from the loan and deposit activities of customers; 2) they provide a source of pledged assets for securing public deposits, bankruptcy deposits and certain borrowed funds which require collateral; 3) they constitute a large base of assets with maturity and interest rate characteristics that can be changed more readily than the loan portfolio, to better match changes in the deposit base and other funding sources of the Company; 4) they are another interest-earning option for surplus funds when loan demand is light; and 5) they can provide partially tax exempt income. Aggregate investments totaled $562 million, or 22% of total assets at December 31, 2018, compared to $567 million, or 24% of total assets at December 31, 2017.

We had no fed funds sold at the end of the reporting periods, and interest-bearing balances held primarily in our Federal Reserve Bank account totaled $2 million at December 31, 2018 relative to $9 million at December 31,

2017. The Company's investment securities portfolio had a book balance of $560 million at December 31, 2018, reflecting a net increase of $2 million for 2018. The Company carries investments at their fair market values. We currently have the intent and ability to hold our investment securities to maturity, but the securities are all marketable and are classified as "available for sale" to allow maximum flexibility with regard to interest rate risk and liquidity management. The expected average life for bonds in our investment portfolio was 4.1 years and their average effective duration was 3.3 years at December 31, 2018, up slightly from an expected average life of 4.0 years and an average effective duration of 3.1 years at year-end 2017.

The following Investment Portfolio table reflects the amortized cost and fair market values for each primary category of investment securities for the past three years:

Investment Portfolio-Available for Sale
(dollars in thousands)

	As of December 31,					
	2018		2017		2016	
	Amortized Cost	Fair Market Value	Amortized Cost	Fair Market Value	Amortized Cost	Fair Market Value
U.S. government agencies	$15,553	$ 15,212	$21,524	$ 21,326	$26,926	$ 26,468
Mortgage-backed securities	414,208	404,733	399,203	393,802	391,555	387,876
State and political subdivisions	140,181	140,534	140,909	143,201	114,140	114,193
Equity securities	—	—	—	—	500	1,546
Total securities	$569,942	$ 560,479	$561,636	$ 558,329	$533,121	$ 530,083

The net unrealized loss on our investment portfolio, or the amount by which aggregate fair market values fell short of amortized cost, was $9 million at December 31, 2018, an increase of $6 million relative to the net unrealized loss of $3 million at December 31, 2017. The change was caused by the adverse impact of rising market interest rates on fixed-rate bond values. The balance of U.S. Government agency securities in our portfolio declined by $6 million, or 29%, during 2018 due primarily to bond maturities. Mortgage-backed securities increased by $11 million, or 3%, due to bond purchases, net of prepayments in the portfolio and changes in fair market values. Municipal bond balances were down $3 million, or 2%, as maturities/redemptions and declines in market valuations offset the impact of bond purchases. Municipal bonds purchased in recent periods have strong underlying ratings, and all municipal bonds in our portfolio undergo a detailed quarterly review for potential impairment.

Investment securities that were pledged as collateral for Federal Home Loan Bank borrowings, repurchase agreements, public deposits and other purposes as required or permitted by law totaled $217 million at December 31, 2018 and $183 million at December 31, 2017, leaving $343 million in unpledged debt securities at December 31, 2018 and $376 million at December 31, 2017. Securities that were pledged in excess of actual pledging needs and were thus available for liquidity purposes, if needed, totaled $9 million at December 31, 2018 and $40 million at December 31, 2017.

The table below groups the Company’s investment securities by their remaining time to maturity as of December 31, 2018, and provides weighted average yields for each segment. Since the actual timing of principal payments may differ from contractual maturities when obligors have the right to prepay principal, maturities for mortgage-backed securities (including collateralized mortgage obligations) were determined by incorporating expected prepayments.

Maturity and Yield of Available for Sale Investment Portfolio
(dollars in thousands)

	December 31, 2018									
	Within One Year		After One But Within Five Years		After Five Years But Within Ten Years		After Ten Years		Total	
	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield
	$497	1.50 %	$14,242	2.14 %	$473	3.49 %	$—	—	$15,212	2.16 %

U.S. government agencies										
Mortgage-backed securities	3,152	2.64 %	382,049	2.38 %	19,532	2.85 %	—	—	404,733	2.40 %
State and political subdivisions	6,579	4.69 %	13,861	4.27 %	36,650	3.47 %	83,444	3.64 %	140,534	3.71 %
Total securities	$ 10,228		$ 410,152		$ 56,655		$ 83,444		$ 560,479	

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Cash and Due from Banks

Interest-earning cash balances were discussed above in the "Investments" section, but the Company also maintains a certain level of cash on hand in the normal course of business as well as non-earning deposits at other financial institutions. Our balance of cash and due from banks depends on the timing of collection of outstanding cash items (checks), the amount of cash held at our branches and our reserve requirement, among other things, and is subject to significant fluctuations in the normal course of business. While cash flows are normally predictable within limits, those limits are fairly broad and the Company manages its short-term cash position through the utilization of overnight loans to, and borrowings from, correspondent banks, including the Federal Reserve Bank and the Federal Home Loan Bank. Should a large "short" overnight position persist for any length of time, the Company typically raises money through focused retail deposit gathering efforts or by adding brokered time deposits. If a "long" position is prevalent, we will let brokered deposits or other wholesale borrowings roll off as they mature, or we might invest excess liquidity into longer-term, higher-yielding bonds. The Company's balance of noninterest earning cash and balances due from correspondent banks totaled $72 million, or 3% of total assets at December 31, 2018, and $61 million, or 3% of total assets at December 31, 2017. The average balance of non-earning cash and due from banks, which is a better measure for ascertaining trends, was $61 million for 2018 relative to an average balance of $53 million in 2017. The increase in the average balance in 2018 is due to the impact of vault cash required for acquired and de novo branches, as well as a larger average volume of cash items in process of collection incidental to an expanding base of deposit customers.

Premises and Equipment

Premises and equipment are stated on our books at cost, less accumulated depreciation and amortization. The cost of furniture and equipment is expensed as depreciation over the estimated useful life of the related assets, and leasehold improvements are amortized over the term of the related lease or the estimated useful life of the improvements, whichever is shorter.

The following premises and equipment table reflects the original cost, accumulated depreciation and amortization, and net book value of fixed assets by major category, for the years noted:

Premises and Equipment
(dollars in thousands)

	As of December 31,								
	2018			2017			2016		
	Cost	Accumulated Depreciation and Amortization	Net Book Value	Cost	Accumulated Depreciation and Amortization	Net Book Value	Cost	Accumulated Depreciation and Amortization	Net Book Value
Land	$5,751	$—	$5,751	$5,261	$—	$5,261	$5,161	$—	$5,161
Buildings	21,579	10,140	11,439	20,255	9,551	10,704	19,579	8,993	10,586
Furniture and equipment	18,958	14,971	3,987	18,899	14,159	4,740	20,136	15,048	5,088
Leasehold improvements	15,023	7,601	7,422	15,013	6,665	8,348	11,618	6,074	5,544
Construction in progress	901	—	901	335	—	335	2,514	—	2,514
Total	$62,212	$ 32,712	$29,500	$59,763	$ 30,375	$29,388	$59,008	$ 30,115	$28,893

Net premises and equipment increased by only $112,000 in 2018, since depreciation recorded on fixed assets largely offset the impact of the Lompoc branch addition. The net book value of the Company's premises and equipment was

1.2% of total assets at December 31, 2018, relative to 1.3% at December 31, 2017. Depreciation and amortization included in occupancy and equipment expense totaled $3.0 million in 2018 and $2.9 million in 2017.

Other Assets

Goodwill totaled $27 million at December 31, 2018, unchanged for the year, but other intangible assets were up by $221,000, or 4%, as a result of the core deposit intangible for the Lompoc deposits purchased in May 2018 less

amortization expense recorded on core deposit intangibles. The Company's goodwill and other intangible assets are evaluated annually for potential impairment following FASB guidelines, and based on those analytics Management has determined that no impairment exists as of December 31, 2018.

The net cash surrender value of bank-owned life insurance policies increased to $48.2 million at December 31, 2018 from $47.1 million at December 31, 2017, due to the addition of BOLI income to net cash surrender values. Refer to the "Noninterest Revenue and Operating Expense" section above for a more detailed discussion of BOLI and the income it generates.

The line item for "other assets" on the Company's balance sheet totaled $50.6 million at December 31, 2018, an increase of $5.9 million, or 13%, relative to the $44.7 million balance at December 31, 2017. The increase is due mainly to a receivable that was established for the proceeds of an OREO property that was sold in late December 2018. At year-end 2018, the balance of other assets included as its largest components an $11.7 million investment in restricted stock, a net deferred tax asset of $8.7 million, accrued interest receivable totaling $8.6 million, a $7.6 million receivable for the referenced OREO sold in December, a $5.9 million investment in low-income housing tax credit funds, and a $3.0 million investment in a small business investment corporation. Restricted stock is comprised primarily of Federal Home Loan Bank of San Francisco stock held in conjunction with our FHLB borrowings, and is not deemed to be marketable or liquid. Our net deferred tax asset is evaluated as of every reporting date pursuant to FASB guidance, and we have determined that no impairment exists.

Deposits

Deposits represent another key balance sheet category impacting the Company's net interest margin and profitability metrics. Deposits provide liquidity to fund growth in earning assets, and the Company's net interest margin is improved to the extent that growth in deposits is concentrated in less volatile and typically less costly non-maturity deposits such as demand deposit accounts, NOW accounts, savings accounts, and money market demand accounts. Information concerning average balances and rates paid by deposit type for the past three fiscal years is contained in the Distribution, Rate, and Yield table located in the previous section under "Results of Operations–Net Interest

Income and Net Interest Margin." A distribution of the Company's deposits showing the period-end balance and percentage of total deposits by type is presented as of the dates noted in the following table:

Deposit Distribution
(dollars in thousands)

	Year Ended December 31,				
	2018	2017	2016	2015	2014
Interest bearing demand deposits	$101,243	$118,533	$132,586	$125,210	$110,840
Non-interest bearing demand deposits	662,527	635,434	524,552	432,251	390,897
NOW	434,483	405,057	366,238	306,630	275,494
Savings	283,953	283,126	215,693	193,052	167,655
Money market	123,807	171,611	119,417	101,562	117,907
CDAR's < $100,000	—	—	251	306	572
CDAR's ≥ $100,000	—	—	—	13,803	10,727
Customer time deposit < $100,000	93,156	82,885	75,633	75,069	79,292
Customer time deposits ≥ $100,000	367,171	291,740	261,101	216,745	208,311
Brokered deposits	50,000	—	—	—	5,000
Total deposits	$2,116,340	$1,988,386	$1,695,471	$1,464,628	$1,366,695
Percentage of Total Deposits					
Interest bearing demand deposits	4.78 %	5.96 %	7.82 %	8.55 %	8.11 %
Non-interest bearing demand deposits	31.31 %	31.96 %	30.94 %	29.51 %	28.60 %
NOW	20.53 %	20.37 %	21.60 %	20.94 %	20.16 %
Savings	13.42 %	14.24 %	12.72 %	13.18 %	12.27 %
Money market	5.85 %	8.63 %	7.04 %	6.93 %	8.63 %
CDAR's < $100,000	—	—	0.01 %	0.02 %	0.04 %
CDAR's ≥ $100,000	—	—	—	0.94 %	0.78 %
Customer Time deposit < $100,000	4.40 %	4.17 %	4.46 %	5.13 %	5.80 %
Customer Time deposits > $100,000	17.35 %	14.67 %	15.40 %	14.80 %	15.24 %
Brokered deposits	2.36 %	—	—	—	0.37 %
Total	100.00 %	100.00 %	100.00 %	100.00 %	100.00 %

Deposit balances reflect net growth of $128 million, or 6%, during 2018, due to acquired Lompoc branch deposits totaling $34 million at December 31, 2018, the addition of $50 million in wholesale brokered deposits, and growth in customer time deposits. Customer time deposits increased by $86 million, or 23%, due primarily to a marketing campaign targeting those deposits in the fourth quarter of 2018, but the increase also includes about $7 million in time deposits in the acquired Lompoc branch at the end of the year.

Relatively strong organic growth in non-maturity deposits during the first half of 2018 was offset by runoff in the second half, resulting in a net decline of $8 million for the year. Non-interest bearing demand deposit balances were up $27 million, or 4%, and NOW accounts increased by $29 million, or 7%, but part of the growth in those deposit types came from migration out of interest-bearing demand deposit balances, which declined $17 million, or 15%, and money market demand deposits, which were down $48 million, or 28%. The reduction in non-maturity deposits also includes cannibalization resulting from the aforementioned time deposit promotion, although it is Management's belief that some of those deposits would have left the Bank without the promotion.

Management is of the opinion that a relatively high level of core customer deposits is one of the Company's key strengths, and we continue to strive for core deposit retention and growth. Our deposit-targeted promotions are still favorably impacting growth in the number of accounts and it is expected that balances in these accounts will grow over time consistent with our past experience, although given the current highly competitive market for deposits no

assurance can be provided with regard to future core deposit increases.

The scheduled maturity distribution of the Company’s time deposits at the end of 2018 was as follows:

Deposit Maturity Distribution
(dollars in thousands)

	As of December 31, 2018					
	Three months or less	Three to six months	Six to twelve months	One to three years	Over three years	Total
Time certificates of deposit < $100,000	92,276	15,121	29,384	5,099	1,276	143,156
Other time deposits ≥ $100,000	260,506	18,172	83,608	3,868	1,017	367,171
Total	$352,782	$ 33,293	$112,992	$8,967	$2,293	$510,327

Other Borrowings

The Company’s non-deposit borrowings may, at any given time, include fed funds purchased from correspondent banks, borrowings from the Federal Home Loan Bank, advances from the Federal Reserve Bank, securities sold under agreements to repurchase, and/or junior subordinated debentures. The Company uses short-term FHLB advances and fed funds purchased on uncommitted lines to support liquidity needs created by seasonal deposit flows, to temporarily satisfy funding needs from increased loan demand, and for other short-term purposes. The FHLB line is committed, but the amount of available credit depends on the level of pledged collateral.

Total non-deposit interest-bearing liabilities were up by $43 million, or 66%, in 2018, due to increases in FHLB borrowings and customer repurchase agreements. The Company had $56 million in overnight borrowings from the FHLB at December 31, 2018 relative to $22 million at December 31, 2017, for an increase of $34 million. There were no overnight federal funds purchased from other correspondent banks or advances from the FRB on our books at December 31, 2018 or 2017. Repurchase agreements totaled over $16 million at year-end 2018 relative to a balance of $8 million at year-end 2017, for an increase of over $8 million. Repurchase agreements represent “sweep accounts”, where commercial deposit balances above a specified threshold are transferred at the close of each business day into non-deposit accounts secured by investment securities. The Company had junior subordinated debentures totaling $34.8 million at December 31, 2018 and $34.6 million December 31, 2017, in the form of long-term borrowings from trust subsidiaries formed specifically to issue trust preferred securities. The small increase resulted from the amortization of discount on junior subordinated debentures that were part of our acquisition of Coast Bancorp in 2016.

The details of the Company's short-term borrowings are presented in the table below, for the years noted:

Short-term Borrowings (dollars in thousands)	Year Ended December 31,		
	2018	2017	2016
Repurchase Agreements			
Balance at December 31	$16,359	$8,150	$8,094
Average amount outstanding	14,332	8,514	8,371
Maximum amount outstanding at any month end	17,672	11,409	11,877
Average interest rate for the year	0.40 %	0.40 %	0.39 %
Fed funds purchased			
Balance at December 31	$—	$—	$—
Average amount outstanding	22	166	822
Maximum amount outstanding at any month end	850	5,500	8,200
Average interest rate for the year	0.00 %	0.60 %	0.73 %
FHLB advances			
Balance at December 31	$56,100	$21,900	$65,000
Average amount outstanding	8,967	7,074	28,333
Maximum amount outstanding at any month end	56,100	55,000	93,700
Average interest rate for the year	2.19 %	0.82 %	0.45 %

Other Noninterest Bearing Liabilities

Other liabilities are principally comprised of accrued interest payable, other accrued but unpaid expenses, and certain clearing amounts. The Company's balance of other liabilities went down by $5 million, or 17%, during 2018 due to a drop in current taxes payable, a reduction in our liability for future capital commitments associated with low income housing tax credit funds, and lower balances in clearing accounts.

Capital Resources

The Company had total shareholders' equity of $273 million at December 31, 2018, compared to shareholders' equity of $256 million at the end of 2017. The increase of $17 million, or 7%, is due to $29.7 million in net income and approximately $1.5 million in additional capital related to stock options, net of $9.8 million in dividends paid, and a $4.3 million increase in our accumulated other comprehensive loss. We maintained a very strong capital position throughout the recession and in the ensuing years, and our capital remains at relatively high levels in comparison to many of our peer banks.

The Company uses a variety of measures to evaluate its capital adequacy, including risk-based capital and leverage ratios that are calculated separately for the Company and the Bank. Management reviews these capital measurements on a quarterly basis and takes appropriate action to help ensure that they meet or surpass established internal and external guidelines. As permitted by the regulators for financial institutions that are not deemed to be "advanced approaches" institutions, the Company has elected to opt out of the Basel III requirement to include accumulated other comprehensive income in risk-based capital.

The following table sets forth the Company’s and the Bank’s regulatory capital ratios at the dates indicated:

	December 31, 2018		December 31, 2017	
Sierra Bancorp				
Common Equity Tier 1 Capital to Risk-Weighted Assets	12.61	%	12.84	%
Tier 1 Capital to Risk-weighted Assets	14.38	%	14.79	%
Total Capital to Risk-weighted Assets	14.89	%	15.32	%
Tier 1 Capital to Adjusted Average Assets ("Leverage Ratio")	11.49	%	11.32	%
Bank of the Sierra				
Common Equity Tier 1 Capital to Risk-Weighted Assets	14.25	%	14.51	%
Tier 1 Capital to Risk-weighted Assets	14.25	%	14.51	%
Total Capital to Risk-weighted Assets	14.77	%	15.04	%
Tier 1 Capital to Adjusted Average Assets ("Leverage Ratio")	11.39	%	11.14	%

At the end of 2018 the Company and the Bank were both classified as “well capitalized,” the highest rating of the categories defined under the Bank Holding Company Act and the Federal Deposit Insurance Corporation Improvement Act of 1991, and our regulatory capital ratios remained above the median for peer financial institutions. We do not foresee any circumstances that would cause the Company or the Bank to be less than well capitalized, although no assurance can be given that this will not occur. A more detailed table of regulatory capital ratios, which includes the capital amounts and ratios required to qualify as “well capitalized” as well as minimum capital ratios, appears in Note 14 to the Consolidated Financial Statements in Item 8 herein. For additional details on risk-based and leverage capital guidelines, requirements, and calculations and for a summary of changes to risk-based capital calculations which were recently approved by federal banking regulators, see “Item 1, Business – Supervision and Regulation – Capital Adequacy Requirements” and “Item 1, Business – Supervision and Regulation – Prompt Corrective Action Provisions” herein.

Liquidity and Market Risk Management

Liquidity

Liquidity management refers to the Company’s ability to maintain cash flows that are adequate to fund operations and meet other obligations and commitments in a timely and cost-effective manner. Detailed cash flow projections are reviewed by Management on a monthly basis, with various stress scenarios applied to assess our ability to meet liquidity needs under unusual or adverse conditions. Liquidity ratios are also calculated and reviewed on a regular basis. While those ratios are merely indicators and are not measures of actual liquidity, they are closely monitored and we are committed to maintaining adequate liquidity resources to draw upon should unexpected needs arise.

The Company, on occasion, experiences cash needs as the result of loan growth, deposit outflows, asset purchases or liability repayments. To meet short-term needs, we can borrow overnight funds from other financial institutions, draw advances via Federal Home Loan Bank lines of credit, or solicit brokered deposits if customer deposits are not immediately obtainable from local sources. Availability on lines of credit from correspondent banks and the FHLB totaled $524 million at December 31, 2018. An additional $20 million in credit is available from the FHLB if the Company were to pledge sufficient collateral and maintain the required amount of FHLB stock. The Company was also eligible to borrow approximately $64 million at the Federal Reserve Discount Window based on pledged assets at December 31, 2018. Furthermore, funds can be obtained by drawing down excess cash that might be available in the Company’s correspondent bank deposit accounts, or by liquidating unpledged investments or other readily saleable assets. In addition, the Company can raise immediate cash for temporary needs by selling under agreement to repurchase those investments in its portfolio which are not pledged as collateral. As of December 31, 2018,

unpledged debt securities plus pledged securities in excess of current pledging requirements comprised $352 million of the Company's investment balances, as compared to $415 million at December 31, 2017. Other sources of potential liquidity include but are not necessarily limited to any outstanding fed funds sold and vault cash. The Company has

a higher level of actual balance sheet liquidity than might otherwise be the case, since we utilize a letter of credit from the FHLB rather than investment securities for certain pledging requirements. That letter of credit, which is backed by loans pledged to the FHLB by the Company, totaled $95 million at December 31, 2018. Management is of the opinion that available investments and other potentially liquid assets, along with standby funding sources it has arranged, are more than sufficient to meet the Company's current and anticipated short-term liquidity needs.

The Company's net loans to assets and available investments to assets ratios were 69% and 14%, respectively, at December 31, 2018, as compared to internal policy guidelines of "less than 78%" and "greater than 3%." Other liquidity ratios reviewed periodically by Management and the Board include net loans to total deposits and wholesale funding to total assets (including ratios and sub-limits for the various components comprising wholesale funding), which were all well within policy guidelines at December 31, 2018. The Company has been able to maintain a robust liquidity position despite recent loan growth and non-maturity deposit runoff, but no assurance can be provided that our liquidity position will continue at current strong levels.

The holding company's primary uses of funds include operating expenses incurred in the normal course of business, shareholder dividends, and stock repurchases. Its primary source of funds is dividends from the Bank, since the holding company does not conduct regular banking operations. Management anticipates that the Bank will have sufficient earnings to provide dividends to the holding company to meet its funding requirements for the foreseeable future. Both the holding company and the Bank are subject to legal and regulatory limitations on dividend payments, as outlined in Item 5(c) Dividends in this Form 10-K.

Interest Rate Risk Management

Market risk arises from changes in interest rates, exchange rates, commodity prices and equity prices. The Company does not engage in the trading of financial instruments, nor does it have exposure to currency exchange rates. Our market risk exposure is primarily that of interest rate risk, and we have established policies and procedures to monitor and limit our earnings and balance sheet exposure to changes in interest rates. The principal objective of interest rate risk management is to manage the financial components of the Company's balance sheet in a manner that will optimize the risk/reward equation for earnings and capital under a variety of interest rate scenarios.

To identify areas of potential exposure to interest rate changes, we utilize commercially available modeling software to perform monthly earnings simulations and calculate the Company's market value of portfolio equity under varying interest rate scenarios. The model imports relevant information for the Company's financial instruments and incorporates Management's assumptions on pricing, duration, and optionality for anticipated new volumes. Various rate scenarios consisting of key rate and yield curve projections are then applied in order to calculate the expected effect of a given interest rate change on interest income, interest expense, and the value of the Company's financial instruments. The rate projections can be shocked (an immediate and parallel change in all base rates, up or down), ramped (an incremental increase or decrease in rates over a specified time period), economic (based on current trends and econometric models) or stable (unchanged from current actual levels).

In addition to a stable rate scenario, which presumes that there are no changes in interest rates, we typically use at least six other interest rate scenarios in conducting our rolling 12-month net interest income simulations: upward shocks of 100, 200, and 300 basis points, and downward shocks of 100, 200, and 300 basis points. Those scenarios may be supplemented, reduced in number, or otherwise adjusted as determined by Management to provide the most meaningful simulations in light of economic conditions and expectations at the time. We currently utilize an additional upward rate shock scenario of 400 basis points. Pursuant to policy guidelines, we generally attempt to limit the projected decline in net interest income relative to the stable rate scenario to no more than 5% for a 100 basis point (bp) interest rate shock, 10% for a 200 bp shock, 15% for a 300 bp shock, and 20% for a 400 bp shock. As of December 31, 2018 the Company had the following estimated net interest income sensitivity profile, without factoring in any potential negative impact on spreads resulting from competitive pressures or credit quality deterioration:

	Immediate Change in Rate						
	-300 bp	-200 bp	-100 bp	+100 bp	+200 bp	+300 bp	+400 bp
Change in Net Int. Inc. (in $000's)	-$14,214	-$7,112	-$3,166	+$187	+$440	+$325	+$44
% Change	-14.73%	-7.37%	-3.28%	+0.19%	+0.46%	+0.34%	+0.05%

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Our current simulations indicate that the Company's net interest income will remain relatively flat over the next 12 months in a rising rate environment, but a drop in interest rates could have a substantial negative impact. In prior periods the simulations projected sizeable gains in net interest income in rising rate scenarios, but balance sheet changes such as the addition of fixed-rate loans and adjustable-rate loans with longer reset periods, and the recent increase in interest rates have significantly diminished that effect. If there were an immediate and sustained upward adjustment of 100 basis points in interest rates, all else being equal, net interest income over the next 12 months is projected to improve by only $187,000, or 0.19%, relative to a stable interest rate scenario, with the favorable variance contracting very slightly as interest rates rise higher. If interest rates were to decline by 100 basis points, however, net interest income would likely be around $3.166 million lower than in a stable interest rate scenario, for a negative variance of 3.28%. The unfavorable variance increases when rates drop 200 or 300 basis points, due to the fact that certain deposit rates are already relatively low (on NOW accounts and savings accounts, for example), and will hit a natural floor of close to zero while non-floored variable-rate loan yields continue to drop. This effect is exacerbated by accelerated prepayments on fixed-rate loans and mortgage-backed securities when rates decline, although rate floors on some of our variable-rate loans partially offset other negative pressures. While we view material interest rate reductions as unlikely in the near term, we will continue to monitor our interest rate risk profile and will apply remedial changes as deemed appropriate.

In addition to the net interest income simulations shown above, we run stress scenarios for the unconsolidated Bank modeling the possibility of no balance sheet growth, the potential runoff of "surge" core deposits which flowed into the Bank in the most recent economic cycle, and unfavorable movement in deposit rates relative to yields on earning assets (i.e., higher deposit betas). When no balance sheet growth is incorporated and a stable interest rate environment is assumed, projected annual net interest income is about $2 million lower than in our standard simulation. However, the stressed simulations reveal that the Company's greatest potential pressure on net interest income would result from excessive non-maturity deposit runoff and/or unfavorable deposit rate changes in rising rate scenarios.

The economic value (or "fair value") of financial instruments on the Company's balance sheet will also vary under the interest rate scenarios previously discussed. The difference between the projected fair value of the Company's financial assets and the fair value of its financial liabilities is referred to as the economic value of equity ("EVE"), and changes in EVE under different interest rate scenarios are effectively a gauge of the Company's longer-term exposure to interest rate fluctuations. Fair values for financial instruments are estimated by discounting projected cash flows (principal and interest) at anticipated replacement interest rates for each account type, while the fair value of non-financial accounts is assumed to equal their book value for all rate scenarios. An economic value simulation is a static measure utilizing balance sheet accounts at a given point in time, and the measurement can change substantially over time as the Company's balance sheet evolves and interest rate and yield curve assumptions are updated.

The change in economic value under different interest rate scenarios depends on the characteristics of each class of financial instrument, including stated interest rates or spreads relative to current or projected market-level interest rates or spreads, the likelihood of principal prepayments, whether contractual interest rates are fixed or floating, and the average remaining time to maturity. As a general rule, fixed-rate financial assets become more valuable in declining rate scenarios and less valuable in rising rate scenarios, while fixed-rate financial liabilities gain in value as interest rates rise and lose value as interest rates decline. The longer the duration of the financial instrument, the greater the impact a rate change will have on its value. In our economic value simulations, estimated prepayments are factored in for financial instruments with stated maturity dates, and decay rates for non-maturity deposits are projected based on historical patterns and Management's best estimates. Our EVE has increased in recent periods due to asset growth and higher discount rates, which result in a larger benefit assessed to non-maturity deposits. The table below shows estimated changes in the Company's EVE as of December 31, 2018, under different interest rate scenarios relative to a base case of current interest rates:

Immediate Change in Rate						
-300 bp	-200 bp	-100 bp	+100 bp	+200 bp	+300 bp	+400 bp

Change in EVE (in $000's)	-$150,691	-$146,922	-$61,849	+$26,094	+$41,670	+$49,586	+$54,000
% Change	-25.85%	-25.21%	-10.61%	+4.48%	+7.15%	+8.51%	+9.26%

The table shows that our EVE will generally deteriorate in declining rate scenarios, but should benefit from a parallel shift upward in the yield curve. The change in EVE flattens out as interest rates drop more than 200 basis points, while the rate of increase in EVE begins to taper off the higher interest rates rise. This phenomenon is caused by the relative durations of our fixed-rate assets and liabilities, combined with optionality inherent in our balance sheet. We

also run stress scenarios for the unconsolidated Bank's EVE to simulate the possibility of higher loan prepayment rates, unfavorable changes in deposit rates, and higher deposit decay rates. Model results are highly sensitive to changes in assumed decay rates for non-maturity deposits, in particular, with material unfavorable variances occurring relative to the standard simulations shown above as decay rates are increased. Furthermore, while not as extreme as the variances produced by increasing non-maturity deposit decay rates, EVE also displays a relatively high level of sensitivity to unfavorable changes in deposit rate betas in rising interest rate scenarios.

Item 7A. Quantitative and Qualitative Disclosures about Market Risk

The information concerning quantitative and qualitative disclosures of market risk called for by Item 305 of Regulation S-K is included as part of Item 7 above. See "Management's Discussion and Analysis of Financial Condition and Results of Operations – Liquidity and Market Risk Management".

Item 8. Financial Statements and Supplementary Data

The following financial statements and independent auditors' reports listed below are included herein:

		Page
I.	Report of Independent Registered Public Accounting Firm from Vavrinek, Trine, Day & Co., LLP	57
II.	Consolidated Balance Sheets – December 31, 2018 and 2017	59
III.	Consolidated Statements of Income – Years Ended December 31, 2018, 2017, and 2016	60
IV.	Consolidated Statements of Comprehensive Income – Years Ended December 31, 2018, 2017, and 2016	61
V.	Consolidated Statements of Changes in Shareholders' Equity – Years Ended December 31, 2018, 2017, and 2016	62
VI.	Consolidated Statements of Cash Flows – Years Ended December 31, 2018, 2017, and 2016	63
VII.	Notes to Consolidated Financial Statements	66

Report of Independent Registered Public Accounting Firm

Board of Directors and Shareholders

Sierra Bancorp and Subsidiary

Porterville, California

Opinions on the Consolidated Financial Statements and Internal Control over Financial Reporting

We have audited the accompanying consolidated balance sheets of Sierra Bancorp and Subsidiary (the "Company") as of December 31, 2018 and 2017, and the related consolidated statements of income and comprehensive income, of changes in shareholders' equity, and of cash flows for each of the years in the three year period ended December 31, 2018, and the related notes (collectively referred to as the "financial statements"). We also have audited the Company's internal control over financial reporting as of December 31, 2018, based on criteria established in Internal Control - Integrated Framework: (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Company as of December 31, 2018 and 2017, and the results of its operations and its cash flows for each of the years in the three year period ended December 31, 2018 in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2018, based on criteria established in Internal Control - Integrated Framework: (2013) issued by the COSO.

Basis for Opinions

The Company's management is responsible for these financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Company's financial statements and on the Company's internal control over financial reporting based on our integrated audits. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) ("PCAOB") and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud, and whether effective internal control over financial reporting was maintained in all material respects.

Our audits of the financial statements included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

Definition and Limitations of Internal Control Over Financial Reporting

A company's internal control over financial reporting is a process designed 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. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally

accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

/s/ Vavrinek, Trine, Day & Co., LLP

We have served as the Company's auditor since 2004.

Rancho Cucamonga, California

March 14, 2019

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SIERRA BANCORP AND SUBSIDIARY

CONSOLIDATED BALANCE SHEETS

December 31, 2018 and 2017

(dollars in thousands)

	2018	2017
ASSETS		
Cash and due from banks	$72,439	$61,142
Interest-bearing deposits in banks	1,693	8,995
Cash and cash equivalents	74,132	70,137
Securities available-for-sale	560,479	558,329
Loans and leases:		
Gross loans and leases	1,731,928	1,557,820
Allowance for loan and lease losses	(9,750)	(9,043)
Deferred loan and lease costs, net	2,602	2,774
Net loans and leases	1,724,780	1,551,551
Foreclosed assets	1,082	5,481
Premises and equipment, net	29,500	29,388
Goodwill	27,357	27,357
Other intangible assets, net	6,455	6,234
Company owned life insurance	48,153	47,108
Other assets	50,564	44,713
	$2,522,502	$2,340,298
LIABILITIES AND SHAREHOLDERS' EQUITY		
Deposits:		
Non-interest bearing	$662,527	$635,434
Interest bearing	1,453,813	1,352,952
Total deposits	2,116,340	1,988,386
Repurchase agreements	16,359	8,150
Short-term borrowings	56,100	21,900
Subordinated debentures, net	34,767	34,588
Other liabilities	25,912	31,332
Total liabilities	2,249,478	2,084,356
Commitments and contingent liabilities (Notes 5 & 12)		
Shareholders' equity		
Serial Preferred stock, no par value; 10,000,000 shares authorized; none issued; Common stock, no par value; 24,000,000 shares authorized; 15,300,460 and 15,223,360 shares issued and outstanding in 2018 and 2017, respectively	112,507	111,138
Additional paid-in capital	3,066	2,937
Retained earnings	164,117	144,197
Accumulated other comprehensive loss, net of taxes of $(2,798) in 2018 and $(977) in 2017	(6,666)	(2,330)
Total shareholders' equity	273,024	255,942
	$2,522,502	$2,340,298

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

SIERRA BANCORP AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF INCOME

Years Ended December 31, 2018, 2017 and 2016

(dollars in thousands, except per share data)

	2018	2017	2016
Interest and dividend income			
Loans and leases, including fees	$87,792	$68,227	$57,450
Taxable securities	9,548	8,614	7,922
Tax-exempt securities	4,060	3,711	3,009
Dividend income on securities	—	16	40
Federal funds sold and other	238	356	84
Total interest income	101,638	80,924	68,505
Interest expense			
Deposits	7,260	3,762	2,174
Short-term borrowings	253	93	166
Subordinated debentures	1,731	1,368	983
Total interest expense	9,244	5,223	3,323
Net interest income	92,394	75,701	65,182
Provision (benefit) for loan and lease losses	4,350	(1,140)	—
Net interest income after provision for loan and lease losses	88,044	76,841	65,182
Non-interest income			
Service charges on deposits	12,439	11,230	10,151
Gain on sale of loans	—	3	2
Checkcard fees	5,878	4,955	4,467
Net gains on sale of securities available-for-sale	2	500	223
Increase in cash surrender value of life insurance	591	1,640	994
Other income	2,654	3,451	3,401
Total non-interest income	21,564	21,779	19,238
Non-interest expense			
Salaries and employee benefits	36,133	31,506	27,452
Occupancy and equipment	10,295	9,590	7,766
Acquisition costs	449	2,225	2,411
Other	23,147	22,120	20,424
Total non-interest expense	70,024	65,441	58,053
Income before income taxes	39,584	33,179	26,367
Provision for income taxes	9,907	13,640	8,800
Net income	$29,677	$19,539	$17,567
Earnings per share			
Basic	$1.94	$1.38	$1.30
Diluted	$1.92	$1.36	$1.29
Weighted average shares outstanding, basic	15,261,794	14,172,196	13,530,293
Weighted average shares outstanding, diluted	15,432,120	14,357,782	13,651,804

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

SIERRA BANCORP AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

Years Ended December 31, 2018, 2017 and 2016

(dollars in thousands, except footnotes)

	2018	2017	2016
Net income	$29,677	$19,539	$17,567
Other comprehensive loss, before tax:			
Unrealized (loss) gain on securities:			
Unrealized holding (loss) gain arising during period	(6,154)	231	(7,245)
Reclassification adjustment for gain included in net income [1]	(2)	(500)	(223)
Other comprehensive loss, before tax	(6,156)	(269)	(7,468)
Income tax benefit related to items of other comprehensive income	1,820	112	3,162
Total other comprehensive loss, net of tax	(4,336)	(157)	(4,306)
Comprehensive income	25,341	19,382	13,261

(1) Amounts are included in net gains on securities available-for-sale on the Consolidated Statements of Income in non-interest income. Income tax expense associated with the reclassification adjustment for the years ended 2018, 2017 and 2016 was $0, $210,000 and $94,000 respectively.

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

SIERRA BANCORP AND SUBSIDIARY

CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS' EQUITY

For the Three Years Ended December 31, 2018

(dollars in thousands, except per share data)

	Common Stock					
	Shares	Amount	Additional Paid In Capital	Retained Earnings	Accumulated Other Comprehensive Income (loss)	Shareholders' Equity
Balance, January 1, 2016	13,254,088	$62,404	$ 2,689	$122,701	$ 2,546	$ 190,340
Net Income				17,567		17,567
Other comprehensive loss, net of tax					(4,306)	(4,306)
Exercise of stock options and related tax benefits of $146	48,640	694	(45)			649
Stock compensation costs			188			188
Stock repurchase	(125,365)	(677)		(1,582)		(2,259)
Stock issued-acquisition	599,226	10,205				10,205
Cash dividends - $.48 per share				(6,506)		(6,506)
Balance, December 31, 2016	13,776,589	72,626	2,832	132,180	(1,760)	205,878
Net Income				19,539		19,539
Other comprehensive loss, net of tax					(157)	(157)
Tax act reclassification				413	(413)	—
Exercise of stock options	70,340	1,141	(377)			764
Stock compensation costs			476			476
Stock repurchase						—
Stock issued-acquisition	1,376,431	37,371	6			37,377
Cash dividends - $.56 per share				(7,935)		(7,935)
Balance, December 31, 2017	15,223,360	111,138	2,937	144,197	(2,330)	255,942
Net Income				29,677		29,677
Other comprehensive loss, net of tax					(4,336)	(4,336)
Exercise of stock options	77,100	1,369	(238)			1,131
Stock compensation costs			373			373
Stock repurchase						—
Stock issued-acquisition			(6)			(6)
Cash dividends - $.64 per share				(9,757)		(9,757)
Balance, December 31, 2018	15,300,460	$112,507	$ 3,066	$164,117	$ (6,666)	$ 273,024

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

SIERRA BANCORP AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF CASH FLOWS

Years Ended December 31, 2018, 2017, and 2016

(dollars in thousands)

	2018	2017	2016
Cash flows from operating activities:			
Net income	$29,677	$19,539	$17,567
Adjustments to reconcile net income to net cash provided by operating activities:			
Gain on sales of securities	(2)	(500)	(223)
Gain on sale of loans	—	(3)	(2)
Loss on disposal of fixed assets	16	136	