2017

Malaga

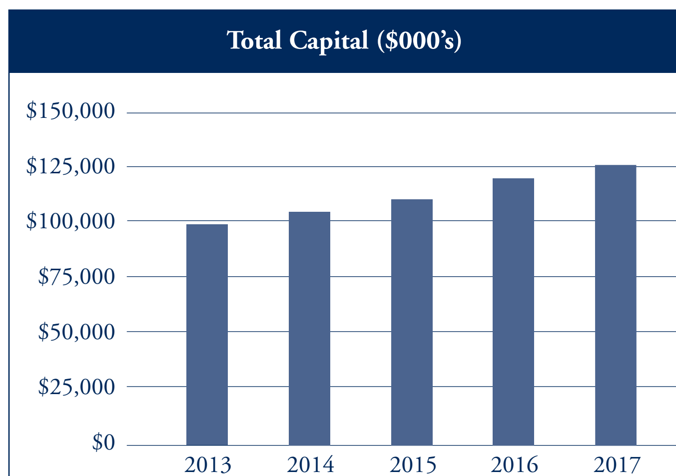
FINANCIAL CORPORATION

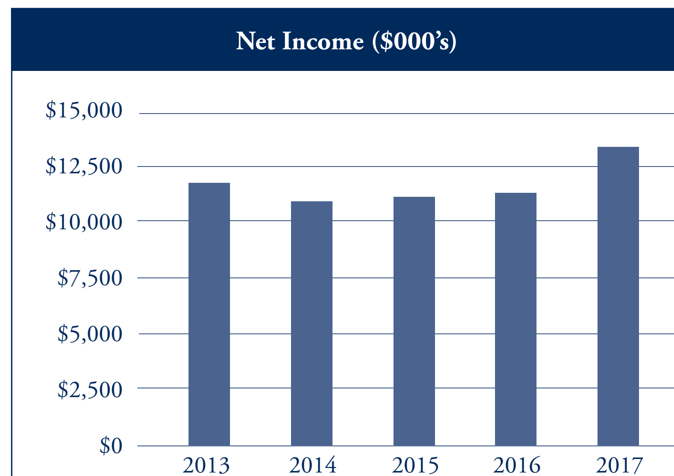
ANNUAL REPORT

We wish to express our thanks for the opportunity to serve the residents and businesses of Palos Verdes and the surrounding communities for the last thirty-three years. We look forward to continuing to be your local community bank of choice in the years to come.

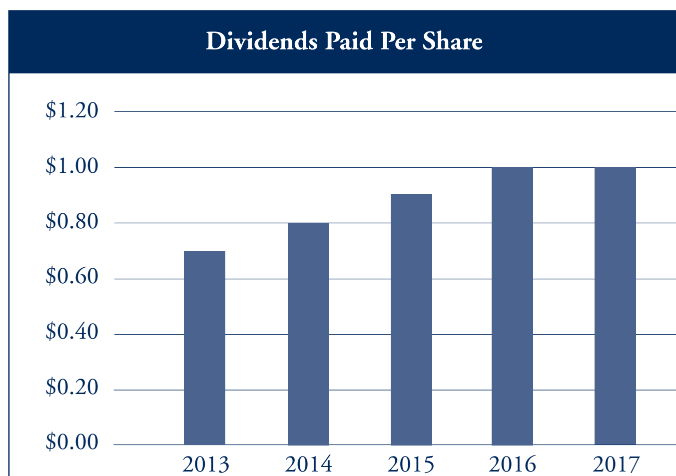
FINANCIAL STRENGTH

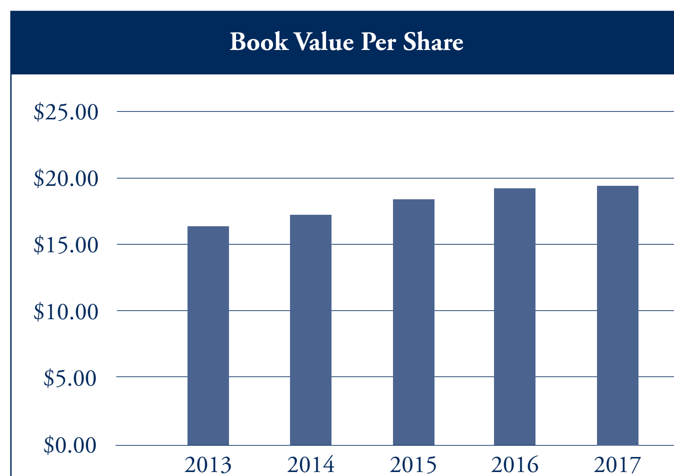
Record Capital and Income





Shareholder Value





2017 ACCOMPLISHMENTS

Record earnings.

Excellent asset quality.

Strong capital levels.

Quarterly cash dividends for the 54th consecutive quarter and special 5% stock dividends at year-end 2017.

For over 10 years Malaga Bank has been consistently awarded premier Top 5-Star rating by one of the nation's leading independent bank rating and reseach firms, Bauer Financial.

*Malaga Bank is a wholly owned subsidiary of Malaga Financial Corporation.

DEAR SHAREHOLDERS AND FRIENDS,

2017 was another successful year for Malaga Financial Corporation and its subsidiary, Malaga Bank. We reported record earnings for 2017, and continued to pay quarterly cash dividends in addition to a special 5% stock dividend at year-end 2017. Earnings benefitted from the Tax Cut and Job Act enacted on December 22, 2017 by the amount of $823,000. The year continued to present a challenging operating environment which included; heightened regulatory expectations, intense competitive pressure—for both loans and deposits—and economic growth generally below expectations. Also, action by the Federal Reserve to increase interest rates were once again below early market expectations as the economy continued to show only modest progress. In spite of these challenges we were able to achieve the following results:

- A 14.43% stock price increase to $29.58 as of December 31, 2017
- Book value per share increased from $19.10 to $19.30 after the issuance of the 5% stock dividend
- Earnings per share of $2.18 (basic) and $2.16 (fully diluted)
- Net Income of $13.5 million
- Return on pre-tax average equity (ROE) was 17.58%
- Return on average equity (ROE) was 11.12%
- Return on average assets (ROA) was 1.33%
- Excellent credit quality with no non-performing assets/foreclosures at year-end

Shareholders benefitted from price growth in addition to cash dividends of $1.00 per share, and a special year-end 5% stock dividend. Capital levels remained stable with a 13.23% core capital ratio and a 24.18% risk-based ratio at year-end 2017, substantially exceeding the minimum "well-capitalized" requirements of 5% and 10%, respectively.

Total gross loans at December 31, 2017 were $949.6 million, up $52.5 million or 6% from prior year-end. Loan growth was restrained by increasing competition reflected by both relaxed underwriting standards and aggressive pricing; however, we continue to adhere to our past discipline placing our emphasis on safe, conservative underwriting over growth.

Malaga Bank was awarded the Bauer Financial Inc. premier Top 5-Star rating for the 40th consecutive quarter as of September 2017. Bauer Financial Inc. is one of the nation's leading independent bank rating and research firms. In July 2017, Malaga Bank was awarded the Daily Breeze 26th annual Readers Choice Award as the South Bay's Best Bank.

We anticipate challenges in 2018 to include rising interest rates, increasing political and economic uncertainty, and unforeseen new obstacles; however, we remain confident that we will find new opportunities to enhance future growth and profitability. We anticipate the lower tax rate will continue to have a positive impact on earnings in 2018 and future years.

On behalf of Malaga Financial Corporation and Malaga Bank, we thank our board of directors, management, and staff for their commitment and contributions to our day to day success, and you, our shareholders, for your loyalty, your business, and your investment.

Randy Bowers

President and
Chief Executive Officer

Richard Oas

Chairman of the Board

MANAGEMENT'S DISCUSSION AND ANALYSIS

The following discussion and financial information is presented to aid in understanding results of operations and financial condition of Malaga Financial Corporation ("MFC") and its consolidated subsidiary, Malaga Bank FSB ("Malaga Bank"). In this discussion, references to the "Company" or "we" or "us" refer to MFC and Malaga Bank.

OVERVIEW

MFC is the holding company for Malaga Bank, and the stock of Malaga Bank is MFC's primary asset. Malaga Bank is a full service community bank with headquarters located on the Palos Verdes Peninsula in Southern California. It is the largest independent bank headquartered in the South Bay area of Los Angeles.

We originate primarily adjustable rate multifamily (apartment) mortgage loans in Los Angeles and Orange counties and to a lesser extent single-family residential loans, consumer loans, construction loans, commercial mortgage loans and commercial loans. At December 31, 2017, multifamily mortgage loans represented 81% of our loan portfolio and loans represented 92% of our total assets.

In 2017, our market area for deposits continued to be concentrated in the areas immediately surrounding our five branch offices in Palos Verdes Estates, Rolling Hills Estates, Torrance and San Pedro, California.

RESULTS OF OPERATIONS

Our net income was $13.5 million in 2017 compared to net income of $11.6 million in the previous year, an increase of $1.9 million or 17%. Earnings per share for 2017 were $2.18 (basic) and $2.16 (fully diluted), compared to $1.80 (basic) and $1.79 (fully diluted) in 2016.

As a result of the Tax Cut and Jobs Act enacted on December 22, 2017, the Company was required to remeasure its deferred tax assets and liabilities. The remeasurement resulted in a decrease of $823,000 in income tax expense provision for the year ended December 31, 2017. Excluding the effect of this re-measurement, net income for the year ended December 31, 2017 was $12.7 million ($2.05 basic and $2.03 fully diluted earnings per share) a 9% increase over the prior year.

Our return on average assets (ROA) was 1.33% in 2017 compared to 1.16% in 2016. Our return on average equity (ROE) was 11.12% in 2017 compared to 10.09% in 2016.

The following table sets forth selected financial data for the past five years:

	2017	2016	2015	2014	2013
Total assets (000's)	$1,041,067	$ 981,376	$ 984,382	$ 947,282	$ 886,852
Stockholders' equity (000's)	$ 125,986	$ 117,341	$ 111,007	$ 104,225	$ 97,079
Net income (000's)	$ 13,500	$ 11,559	$ 11,406	$ 11,211	$ 11,494
Basic earnings per share*	$ 2.18	$ 1.80	$ 1.79	$ 1.78	$ 1.84
Diluted earnings per share*	$ 2.16	$ 1.79	$ 1.78	$ 1.77	$ 1.83
Dividends paid per share	$ 1.00	$ 1.00	$ .90	$ .80	$ .70
ROA	1.33%	1.16%	1.16%	1.22%	1.34%
ROE	11.12%	10.09%	10.55%	11.07%	12.25%

*Adjusted for the 5% stock dividend on December 29, 2017

On December 29, 2017, a 5% stock dividend was paid which increase the amout of shares ourstanding by 310,782.

NET INTEREST INCOME

Net interest income is the primary component of our income. The chief determinants of net interest income are the dollar amounts of interest-earning assets and interest-bearing liabilities and the interest rates earned or paid on these assets and liabilities. The greater the excess of average interest-earning assets over average interest-bearing liabilities, the more beneficial the impact on net interest income.

Our net interest income increased by $1.7 million to $32.3 million in 2017 as a result of a higher level of average interest-earning assets over average interest-bearing liabilities and an increase in the interest rate spread. The interest rate spread (the difference between the weighted-average yield on average interest-earning assets and the weighted-average rate paid on average interest-bearing liabilities)

increased from 3.04% in 2016 to 3.18% in 2017. The increase in the interest rate spread was primarily attributable to an increase in yield on average interest-earning assets of 0.05%, and decrease in the average cost of funds of 0.09%. The increase in yield on average interest-earning assets is primarily due to increase in average loans outstanding offset by decrease in average loan yield of 0.09%. Also contributing to the increase was a decrease of 0.09% in the average cost of funds as we shifted a greater percentage of our interest bearing liabilities to lower cost FHLB overnight borrowings and repaid our outstanding senior subordinated notes of $10,000,000 at maturity on December 30, 2016. Average interest-earning assets increased $12.4 million from 2016 and average interest-bearing liabilities increased $5.3 million for the same period.

The following table sets forth the weighted-average balances, yields earned and rates paid with respect to the major components of our interest-earning assets and interest-bearing liabilities, and net interest rate spread, for the periods indicated:

WEIGHTED-AVERAGE BALANCES AND RATES

	2017		2016	
	(000's)		(000's)	
Loans receivable	$ 927,774	3.92%	$ 881,024	4.01%
Federal funds sold	40,498	1.15	75,752	0.52
Interest-bearing deposits in banks	18,896	1.20	18,112	0.78
FHLB stock	6,402	7.76	6,304	12.21
Total interest-earning assets	993,570	3.78	981,192	3.73
Deposits	763,286	0.39	758,961	0.31
FHLB borrowings	105,001	1.72	94,030	2.53
Senior subordinated notes	-	0.00	10,000	9.25
Junior subordinated debentures	13,404	3.53	13,404	3.02
Total interest-bearing liabilities	881,691	0.60	876,395	0.69
Excess of interest-earning assets over interest-bearing liabilities; interest rate spread	$ 111,879	3.18 %	$ 104,797	3.04%

PROVISIONS FOR CREDIT LOSSES

We recorded a provision for credit losses of $93,000 in 2017 versus $51,000 in 2016. There were three charge-offs totaling $22,200 in 2017 and two charge-offs totaling $5,500 in 2016.

OTHER OPERATING INCOME

Other operating income, which consists primarily of deposit related fees, increased $87,000 from 2016 to 2017.

OTHER OPERATING EXPENSES

The main components of other operating expenses or "overhead" are compensation, office rent and utilities, regulatory assessments and general and administrative expenses. Operating expenses increased $147,000 or 1% from $11.4 million in 2016 to $11.6 million in 2017. This increase was due primarily to a $352,000 increase in compensation, offset by a $28,000 decrease in office rent and utilities, a $54,000 decrease in professional services, a $30,000 decrease in data processing, and an $89,000 decrease in deposit insurance premiums.

We employed 77 full-time equivalent employees at December 31, 2017, with an average of 7.1 years of service. The tenure and experience of our employees continue to be a major part of our successful and efficient operations.

Banks measure their ability to manage overhead through an efficiency ratio expressed as total overhead expenses as a percentage of net interest income and other operating income. Malaga Bank's efficiency ratios of 33.98% in 2017 and 34.55% in 2016 continued to be very favorable compared to the efficiency ratios of our peers, insured savings banks having assets between $300 million and $1 billion, which averaged 62.46% in 2017 and 73.66% in 2016. Another measure of overhead efficiency is the percentage of overhead expense to average assets. Malaga Bank's ratio was 1.12% in 2017 and 2016, which compared with our peer group average of 2.61% and 3.05% in 2017 and 2016, respectively. Malaga Bank had $12.8 million in average assets per employee at December 31, 2017 as compared to $12.6 million in average assets per employee at December 31, 2016.

FINANCIAL CONDITION

Total assets increased to $1.0 billion at December 31, 2017 from $981.4 million at December 31, 2016.

LOAN PORTFOLIO

Total gross loans at December 31, 2017 were $949.6 million, up $52.5 million or 6% from the prior year-end. Our primary lending emphasis continued to be multifamily mortgage loans, which comprised 81% of our loan portfolio at December 31, 2017. The weighted-average yield on the loan portfolio was 3.92% at December 31, 2017 and 4.01% at December 31, 2016.

CREDIT LOSS RESERVES AND NON-PERFORMING ASSETS

Our allowance for credit losses, including reserves for losses on commitments for lines of credit and construction loans, totaled $3.1 million at December 31, 2017 and $3.0 million at December 31, 2016. As of December 31, 2017, there was one loan for $228,000 or 0.02% of total loans past due 30-59 days, and all other loans were current. As of December 31, 2016, there was one loan for $186,500 or 0.02% of total loans past due 30-59 days. Our allowance for credit losses to total loans outstanding was 0.33% at December 31, 2017 and 0.34% at December 31, 2016.

Management's determination of the adequacy of the allowance for credit losses requires the use of judgment and estimates that may change in the future. Some factors considered by management in determining the adequacy of the allowance include: detailed reviews of individual loans; gross and net charge-offs in the current year; historical loss levels; past due and non-accruing loans; collateral values of properties securing loans; types of loans and risk profiles; and management's analysis of current economic conditions and the resulting impact on the loan portfolio. Changes in the factors used by management to determine the adequacy of the allowance, or the availability of new information, could cause the allowance for credit losses to be increased or decreased. In addition, bank regulatory agencies, as a part of their examination process, may require that additions be made to the allowance for credit losses based on their judgment and estimates.

DEPOSITS

Our deposit strategy in 2017 continued to focus on attracting core customer relationships at our branches. Total deposits increased by $2.3 million to $755.5 million at December 31, 2017. During the year, non-interest bearing demand deposits increased $3.0 million to $116.8 million, lower cost money market and other accounts decreased $21.9 million to $373.9 million and certificates of deposit increased $21.2 million to $264.7 million. Lower cost money market and other accounts decreased as customers moved to higher yielding certificates of deposits, stocks and real estate investments as interest rates increased. At December 31, 2017, we had outstanding certificates of deposit from the State of California totaling $90 million bearing interest at a weighted-average rate of 1.17%. Our weighted-average cost of deposits was 0.39% at December 31, 2017 and 0.31% at December 31, 2016.

FHLB BORROWINGS

Another major source of funding for us is advances from the Federal Home Loan Bank of San Francisco ("FHLB"). As of December 31, 2017, we had FHLB borrowings totaling $139.0 million as compared to $90.0 million at December 31, 2016. Our FHLB borrowings at December 31, 2017 had an average remaining maturity of 19 months and bore interest at a weighted-average rate of 1.65%. At that date, we had approximately $373 million of unused FHLB borrowing capacity.

JUNIOR SUBORDINATED DEBENTURES

From time to time MFC has issued junior subordinated debentures related to issuance of trust-preferred securities by business trusts MFC has formed in order to generate regulatory capital. This capital has a relatively low cost as interest payments on the debentures are deductible for income tax purposes. At December 31, 2017, MFC had $13.4 million junior subordinated debentures outstanding bearing interest at a weighted-average rate of 3.90% per annum. These debentures mature commencing in 2033.

STOCKHOLDERS' EQUITY AND REGULATORY CAPITAL

Our stockholders' equity grew by $8.6 million or 7% to $126.0 million at December 31, 2017, from $117.3 million at December 31, 2016. The increase was due principally to net income of $13.5 million and proceeds from the exercise of stock options of $1.3 million, net of $6.2 million of dividends to our stockholders.

Malaga Bank continues to be "well capitalized" under applicable regulations. The following table compares Malaga Bank's actual capital ratios at December 31, 2017 to those required by regulatory agencies for capital adequacy and well capitalized classification purposes:

	Malaga Bank	Minimum Capital Requirements	Well Capitalized Requirements
Tier 1 Capital to Average Assets	13.23%	4.00%	5.00%
Total Capital to Risk-Weighted Assets	24.18%	8.00%	10.00%
Common Tier 1 Capital to Risk-Weighted Assets	23.64%	4.50%	6.50%
Tier 1 Capital to Risk-Weighted Assets	23.64%	6.00%	8.00%

STOCKHOLDERS AND STOCK INFORMATION

At December 31, 2017, MFC had 149 stockholders of record. Many of our stockholders purchased stock in connection with the organization of Malaga Bank. MFC's common stock is traded in the OTC PINK market under the symbol MLGF.

On December 29, 2017, the company paid a 5% stock dividend to its stockholders.

CONSOLIDATED BALANCE SHEETS

	DECEMBER 31	
	2017	**2016**
ASSETS		
Cash and due from banks	**$ 24,331,392**	$ 12,752,967
Federal funds sold	**43,891,295**	40,384,355
Cash and cash equivalents	**68,222,687**	53,137,322
Interest-bearing deposits in banks	**3,175,000**	12,700,000
Loans receivable — Net of allowance for credit loss of $3,111,100 (2017) and $3,049,300 (2016)	**953,805,547**	900,745,209
Accrued interest receivable	**2,760,213**	2,596,640
Building, office properties, and equipment — Net	**4,679,726**	4,929,871
Investment in FHLB stock — At cost	**6,422,400**	6,358,500
Other assets	**2,001,228**	908,550
TOTAL	**$ 1,041,066,801**	$ 981,376,092

	2017	2016
LIABILITIES AND STOCKHOLDERS' EQUITY		
LIABILITIES:		
Deposits:		
Noninterest-bearing	**$ 116,795,273**	$ 113,847,149
Interest bearing	**638,683,666**	639,302,950
Total deposits	**755,478,939**	753,150,099
FHLB borrowings	**139,000,000**	90,000,000
Junior subordinated debentures	**13,404,000**	13,404,000
Accrued interest payable	**363,177**	239,072
Other liabilities	**4,764,188**	4,797,647
Deferred tax liability	**2,070,390**	2,444,299
Total liabilities	**915,080,694**	864,035,117
COMMITMENTS AND CONTINGENCIES (Note 4)		
STOCKHOLDERS' EQUITY:		
Common stock, $.001 par value — authorized, 20,000,000 shares; outstanding 6,529,131 shares (2017) and 6,144,749 shares (2016)	**6,529**	6,145
Additional paid-in capital	**29,173,411**	18,654,154
Retained earnings	**96,806,167**	98,680,676
Total stockholders' equity	**125,986,107**	117,340,975
TOTAL	**$ 1,041,066,801**	$ 981,376,092

See notes to consolidated financial statements.

MALAGA FINANCIAL CORPORATION AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF OPERATIONS	YEARS ENDED DECEMBER 31	
	2017	**2016**
INTEREST INCOME:		
Loans	**$ 36,364,039**	$ 35,300,710
Other investments	**1,182,523**	1,305,640
Total interest income	**37,546,562**	36,606,350
INTEREST EXPENSE:		
Deposits	**3,012,206**	2,324,211
Borrowings	**1,805,846**	2,379,496
Senior subordinated notes	**-**	927,534
Junior subordinated debentures	**472,859**	404,182
Total interest expense	**5,290,911**	6,035,423
NET INTEREST INCOME	**32,255,651**	30,570,927
PROVISION FOR CREDIT LOSSES	**93,134**	50,646
NET INTEREST INCOME AFTER PROVISION FOR CREDIT LOSSES	**32,162,517**	30,520,281
OTHER OPERATING INCOME	**771,432**	684,643
OTHER OPERATING EXPENSE:		
Compensation	**6,834,471**	6,482,660
Office rent and utilities	**1,001,672**	1,029,238
Professional services	**193,926**	247,743
Data processing	**953,040**	983,121
Deposit insurance premiums	**307,571**	396,877
Depreciation and amortization	**303,237**	299,047
General and administrative	**1,990,334**	1,998,167
Total other operating expense	**11,584,251**	11,436,853
INCOME BEFORE PROVISION FOR INCOME TAXES	**21,349,698**	19,768,071
PROVISION FOR INCOME TAXES	**7,849,893**	8,208,739
NET INCOME	**$ 13,499,805**	$ 11,559,332
BASIC EARNINGS PER SHARE	**$ 2.18**	$ 1.80
DILUTED EARNINGS PER SHARE	**$ 2.16**	$ 1.79

See notes to consolidated financial statements.

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

FOR THE YEARS ENDED DECEMBER 31, 2017 AND 2016

	Common Stock				
	Number of Shares	Amount	Additional Paid-in Capital	Retained Earnings	Total Stockholders' Equity
BALANCE — January 1, 2016	6,080,349	$ 6,080	$ 17,600,175	$ 93,401,083	$ 111,007,338
Net income	-	-	-	11,559,332	11,559,332
Cash dividends declared	-	-	-	(6,279,739)	(6,279,739)
Stock options exercised	64,400	65	1,039,075	-	1,039,140
Stock options compensation expense	-	-	14,904	-	14,904
BALANCE — December 31, 2016	6,144,749	6,145	18,654,154	98,680,676	117,340,975
Net income	-	-	-	13,499,805	13,499,805
Cash dividends declared	-	-	-	(6,206,245)	(6,206,245)
Stock options exercised	73,600	73	1,307,063	-	1,307,136
Stock dividend	310,782	311	9,167,758	(9,168,069)	-
Stock options compensation expense	-	-	44,436	-	44,436
BALANCE — December 31, 2017	6,529,131	$ 6,529	$ 29,173,411	$ 96,806,167	$ 125,986,107

See notes to consolidated financial statements.

CONSOLIDATED STATEMENTS OF CASH FLOWS

FOR THE YEARS ENDED DECEMBER 31

	2017	2016
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	**$ 13,499,805**	$ 11,559,332
Adjustments to reconcile net income to net cash provided by operating activities:		
Accretion of deferred loan costs — net of fees	**892,829**	1,009,911
Provision for credit losses	**93,134**	50,646
Depreciation and amortization	**303,237**	299,047
Net (decrease) increase in deferred income taxes	**(373,909)**	262,930
Stock options compensation expense	**44,436**	14,904
Net increase in accrued interest receivable and other assets	**(1,256,251)**	(13,760)
Net increase in accrued interest payable and other liabilities	**1,622,837**	569,100
Net cash provided by operating activities	**14,826,118**	13,752,110
CASH FLOWS FROM INVESTING ACTIVITIES:		
Net decrease (increase) in interest-bearing deposits in banks	**9,525,000**	(7,645,000)
Net increase in loans receivable	**(54,046,301)**	(13,226,299)
Purchase of FHLB stock	**(63,900)**	(122,300)
Purchase of premises and equipment	**(53,092)**	(291,317)
Net cash used in investing activities	**(44,638,293)**	(21,284,916)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net increase (decrease) in deposits	**2,328,840**	(3,708,174)
Proceeds from FHLB borrowings	**64,000,000**	20,000,000
Repayment of FHLB borrowings	**(15,000,000)**	(18,000,000)
Repayment of senior subordinated notes	**-**	(10,000,000)
Dividends paid	**(7,738,436)**	(4,743,552)
Proceeds from exercise of stock options	**1,307,136**	1,039,140
Net cash provided by (used in) financing activities	**44,897,540**	(15,412,586)
NET CHANGE IN CASH AND CASH EQUIVALENTS	**15,085,365**	(22,945,392)
CASH AND CASH EQUIVALENTS — Beginning of year	**53,137,322**	76,082,714
CASH AND CASH EQUIVALENTS — End of year	**$ 68,222,687**	$ 53,137,322
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION Cash paid during the year for:		
Interest	**$ 5,166,806**	$ 6,092,156
Income taxes	**$ 8,692,000**	$ 8,139,000
SUPPLEMENTAL SCHEDULE OF NONCASH FINANCING ACTIVITIES		
Dividend payable	**$ -**	$ 1,536,187

See notes to consolidated financial statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS AS OF AND FOR THE YEARS ENDED DECEMBER 31, 2017 AND 2016

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Principles of Consolidation and Presentation — The consolidated financial statements include the accounts of Malaga Financial Corporation ("MFC") and its wholly owned subsidiary, Malaga Bank FSB (the "Bank") (collectively, the "Company"). MFC was formed in 2002 to operate as a holding company for the Bank. In 2003, MFC and the Bank completed a holding company reorganization in which MFC acquired all of the outstanding capital stock of the Bank and the shareholders of the Bank became shareholders of MFC. All intercompany balances and transactions have been eliminated in consolidation.

In June 2003, MFC issued $5,155,000 of junior subordinated debentures to PVP Statutory Trust I and in January 2005, MFC issued $2,578,000 of junior subordinated debentures to PVP Statutory Trust II and $5,671,000 of junior subordinated debentures to PVP Statutory Trust III (the "Trusts"). The Company follows generally accepted accounting principles in the United States of America which determine when variable interest entities should be consolidated and determined that the Trusts should not be consolidated. As a result, the consolidated balance sheets include $13,404,000 as junior subordinated debentures. Also included in other assets in the consolidated balance sheet is $404,000 of investments in the Trusts, which is reported using the cost method.

Nature of Operations — The Company's primary operations are related to traditional banking activities, including the acceptance of deposits and the lending and investing of money. The Company's customers consist of individuals and small-to-midsize businesses located primarily in the Palos Verdes Peninsula and adjoining areas of Los Angeles and Orange Counties, California. The Company operates through six locations, five branches and one loan center, including its headquarters located in the city of Palos Verdes Estates, California.

Use of Estimates in the Preparation of Consolidated Financial Statements — The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America ("GAAP") requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Significant estimates include estimates of the allowance for loan losses and fair value determinations.

Cash and Cash Equivalents — Cash and cash equivalents include cash and due from banks and overnight federal funds sold, all of which have original maturities of less than 90 days at the time of purchase. The Company is required to maintain reserve balances with the Federal Reserve Bank under the Federal Reserve Act. The reserve balance was approximately $10,712,000 and $10,490,000 at December 31, 2017 and 2016, respectively. As of December 31, 2017 and 2016, the Company had cash deposits at other financial institutions in excess of the FDIC insured limits. However, the Company places these deposits with major financial institutions and monitors the financial condition of these institutions, and management believes the risk of loss to be minimal.

Interest-Bearing Deposits in Banks — Interest-bearing deposits in banks mature within one year and are carried at cost.

Loans Receivable — Loans receivable are stated at unpaid principal balances, plus premiums on purchased loans, less the allowance for loan losses and unamortized deferred loan origination fees and costs. Premiums on loans are amortized to interest income using the interest method over the remaining period to contractual maturity. The accrual of interest on loans is discontinued at the time the loan is 90 days delinquent unless the credit is well secured and in the process of collection. Loans are placed on nonaccrual or charged off at an earlier date if collection of principal or interest is considered doubtful.

All interest accrued but not collected for loans that are placed on nonaccrual or charged off are reversed against interest income. The interest on these loans is accounted for on the cash-basis or cost-recovery method, until qualifying for return to accrual. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

A loan is considered impaired when it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the loan. Impaired loans are measured based on the present value of expected future cash flows discounted at the loans' effective interest rates, the loans' estimated market value, or the fair value of the collateral if the loans are collateral dependent. If the fair value of an impaired loan is less than the carrying value, a specific allowance is included in the

allowance for credit losses. Impairment is measured on a loan-by-loan basis for multi-family, construction, and commercial loans. Large groups of smaller balance homogenous loans are collectively evaluated for impairment.

Loans are reported as troubled debt restructurings when the Company grants a concession to a borrower experiencing financial difficulties that it would not otherwise consider. As a result of these concessions, restructured loans are impaired as the Company will not collect all amounts due, both principal and interest, in accordance with the terms of the original loan agreement. Impairment reserves on non-collateral dependent restructured loans are measured by comparing the present value of expected future cash flows on the restructured loans discounted at the interest rate of the original loan agreement to the loan's carrying value. These impairment reserves are recognized as a specific component to be provided for in the allowance for credit losses.

Loan origination fees and certain direct loan origination costs are deferred, and the net fee or cost is recognized as an adjustment to interest income using the interest method over the contractual life of the loans. Other loan fees and charges, representing service costs for prepayment of loans, for delinquent payments, or for miscellaneous loan services, are recorded as income when collected.

The Company's lending is concentrated in surrounding areas of Los Angeles and Orange Counties, and substantially all of the Company's loans have adjustable interest rates.

Allowance for Credit Losses — Management's periodic evaluation of the adequacy of the allowance for credit losses is based on the Company's past loan loss experience, known and inherent risks in the loan portfolio, adverse situations that may affect borrowers' ability to repay, estimated values of underlying collateral, and current economic conditions. The allowance consists of specific, general, and unallocated components. The specific component relates to loans that are classified as impaired. The general component covers non-impaired loans and is based on historical loss experience adjusted for qualitative factors. An unallocated component is maintained to cover uncertainties that could affect management's estimate of probable losses. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

Although management believes that the level of the allowance as of December 31, 2017 is adequate to absorb known and inherent risks in the loan portfolio, no assurances can be given that adverse future economic conditions will not lead to higher amounts of problem loans, provisions for loan losses, or charge-offs.

Building, Office Properties, and Equipment — Building, leasehold improvements, office properties, and equipment are carried at cost, less accumulated depreciation and amortization. The cost of the building is depreciated using the straight-line method over 39 years. Office properties and equipment are depreciated using the straight-line method over the estimated useful lives of the assets (three to seven years). The cost of leasehold improvements is being amortized using the straight-line method over the terms of the related leases or the estimated lives of the improvements, whichever is shorter.

Impairment of Long-Lived Assets — Long-lived assets are reviewed at least annually for impairment. When impairment is indicated, the amount of impairment is the excess of the asset's net book value over its fair value. Furthermore, long-lived assets to be disposed of are reported at the lower of historical cost or fair value, less cost to sell.

Federal Home Loan Bank (FHLB) Stock — The Bank is a member of the FHLB system. Members are required to own a certain amount of stock based on the level of borrowings and other factors. FHLB stock is carried at cost, classified as a restricted security, and both cash and stock dividends are reported as income when earned. An impairment analysis of FHLB stock is performed annually or when events or circumstances indicate possibility of impairment.

Income Taxes — The Company utilizes the liability method in accounting for income taxes. Deferred tax assets or liabilities shown on the balance sheets reflect the tax effects of differences between the tax basis of assets and liabilities and their reported amounts in the financial statements. Under this method, deferred tax assets and liabilities are determined based on the differences between the financial statements and tax basis of assets and liabilities using enacted tax rates in effect for the year in which the differences are expected to reverse. The effect of a change in tax rates for deferred tax assets and liabilities is recognized in income in the period that includes the enacted date.

The Company recognizes the tax benefit from uncertain tax positions only if it is more likely than not that the tax positions will be sustained on examination by the tax authorities, based on the technical merits of the position. The tax benefit is measured based on the largest benefit that has a greater than 50% likelihood of being realized upon ultimate settlement. The Company reviews and evaluates tax positions in its major jurisdictions and determines whether or not there are uncertain tax positions that require financial statement recognition. Based on this review, the Company has determined that no reserves for uncertain tax positions were required to have been recorded as a result of the adoption of such guidance for any of the Company's open tax years. The Company files income tax returns in the U.S. federal jurisdiction and in California. The Company is no longer subject to income tax examinations by taxing authorities for years before 2014 for its

federal filings and 2013 for its California filings. The Company accounts for interest and penalties related to uncertain tax positions as part of its provision for federal and state taxes.

The Tax Cuts and Jobs Act of 2017 was enacted December 22, 2017, and changed the federal corporate tax rate to 21% from 35%, effective January 1, 2018, and preserved the full deductibility of state corporate taxes. Accordingly, the Company has recognized the effects of changes in tax laws and rates on the deferred tax assets and liabilities as of December 31, 2017 (see Note 8 – Income Taxes). The resulting adjustment of $823,000 to decrease the value of the net deferred tax liability was recognized by the Company in December 2017 as tax expense.

Financial Instruments — In the ordinary course of business, the Company has entered into offbalance sheet agreements consisting of commitments to extend credit, commercial letters of credit, and standby letters of credit. Such financial instruments are recorded in the financial statements when they are funded or the related fees are incurred or received.

Capital Stock — The Company has authorized 20 million shares of common stock and no other class of capital stock. All per share amounts have been adjusted to reflect a 5% dividend on December 29, 2017. Each share entitles the holder to one vote on each matter voted on by the shareholders. There are no dividend or liquidation preferences, participation rights, call prices or dates, conversion prices or rates, sinking fund requirements, or unusual voting rights associated with these shares.

Earnings Per Share (EPS) — Basic EPS is determined by dividing net income by the average number of shares of common stock outstanding, while diluted EPS is determined by dividing net income by the average number of shares of common stock outstanding, adjusted for the dilutive effect of common stock equivalents.

Dividends — Dividends are recorded when declared. The Company declared dividends of $1.00 and $1.03 per share of common stock in 2017 and 2016, respectively. On November 16, 2017, the Company declared a 5% stock dividend to shareholders of record at the close of business on December 15, 2017. The stock dividend was paid on December 29, 2017.

Stock-Based Compensation — Compensation costs relating to stock-based compensation transactions are recognized in the statements of operations based upon the grant-date fair value of the stock-based compensation granted by the Company. The effect of stock-based accounting rules is to require entities to measure the cost of director and employee services received in exchange for stock-based compensation and to recognize the cost over the period the director or employee is required to provide services for the award. The Company uses the Black-Scholes option-pricing model. Forfeitures are accounted for when they occur.

Comprehensive Income — Accounting principles require that recognized revenue, expenses, gains and losses be included in net income. Certain changes in shareholders' equity from non-owner sources, such as unrealized gains and losses on available-for-sale securities or defined benefit pension liability adjustments, among other items, are reported within comprehensive income and shown as a separate component of the equity section in the consolidated balance sheets. The Company does not have any other comprehensive income items for the years ended December 31, 2017 and 2016; therefore, total comprehensive income equals net income.

Recent Accounting Pronouncements — In January 2016, the FASB issued ASU No. 2016-01, Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities. The new guidance is intended to improve the recognition and measurement of financial instruments. This ASU requires equity investments (except those accounted for under the equity method of accounting, or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income. In addition, the amendment requires public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes and requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset (i.e., securities or loans and receivables) on the balance sheet or the accompanying notes to the financial statements. This ASU also eliminates the requirement for public business entities to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost on the balance sheet.

The amendment also requires a reporting organization to present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in the instrument specific credit risk (also referred to as "own credit") when the organization has elected to measure the liability at fair value in accordance with the fair value option for financial instruments. ASU No. 2016-01 is effective for financial statements issued for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. Early adoption is permitted for certain provisions. In 2017, the Company early adopted the provision to eliminate the requirement to disclose the methods and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost on the balance sheet. As a result, the presentation of the consolidated financial statements and certain disclosures was changed to reflect the adoption of this update. The adoption of the remaining provisions of ASU No. 2016-01 is not expected to have a material impact on the Company's consolidated financial statements.

2. LOANS RECEIVABLE

Loans receivable as of December 31, 2017 and 2016 are summarized as follows:

Description	2017	2016
Residential mortgage loans–multi-family	**$ 772,103,077**	$ 702,606,290
Residential mortgage loans–single family	**132,825,834**	150,564,134
Commercial real estate loans	**36,724,507**	38,005,373
Construction loans	**4,039,962**	1,304,489
Land loans	**750,000**	1,627,700
Business banking loans	**2,709,817**	2,748,080
Consumer loans	**475,577**	243,526
	949,628,774	897,099,592
Less:		
Allowance for credit losses	**(3,111,100)**	(3,049,300)
Deferred loan costs–net of fees	**7,287,873**	6,694,917
	4,176,773	3,645,617
Total	**$ 953,805,547**	$ 900,745,209

As of December 31, 2017 and 2016, loans with adjustable rates of interest (including loans with an initial fixed rate for 1 to 10 years that subsequently convert to adjustable rate) totaled $947.3 million and $894.9 million, respectively, and loans with fixed rates of interest totaled $2.3 million and $2.2 million, respectively. Adjustable-rate loans are generally indexed to the FHLB's Eleventh District Cost of Funds Index, the 12-Month Constant Maturity Index, the London InterBank Offered Rate (LIBOR), or the prime rate and are subject to limitations on the timing and extent of adjustment. Most adjustable-rate loans adjust within six months of changes in the index rate.

At December 31, 2017 and 2016, real estate loans aggregating $735.0 million and $675.0 million, respectively, were pledged as collateral against FHLB borrowings and real estate loans totaling $138.9 million and $124.5 million, respectively, were pledged to secure deposits held by the state of California. In addition, home equity lines of credit totaling $996,000 and $1.8 million were pledged as collateral to the Federal Reserve Bank discount window at December 31, 2017 and 2016, respectively.

Activity in the allowance for credit losses and unfunded loan commitments for the years ended December 31, 2017 and 2016 is summarized as follows:

	2017	2016
Allowance for credit losses:		
Balance — beginning of year	**$ 3,049,300**	$ 2,992,800
Provision for credit losses	**84,034**	62,046
Charge-offs, net	**(22,234)**	(5,546)
Balance — end of year	**$ 3,111,100**	$ 3,049,300
Reserve for unfunded loan commitments:		
Balance — beginning of year	**$ 44,100**	$ 55,500
Provision for (recovery of) losses on unfunded loan commitments	**9,100**	(11,400)
Balance — end of year	**$ 53,200**	$ 44,100

A breakdown of the allowance for credit losses as of December 31, 2017 and 2016, by loan type, is as follows:

	Multi-Family	Single Family	Commercial	Construction	Land	Business Banking	Consumer	Total
Balance - December 31, 2015	$ 2,417,200	$ 494,500	$ 45,600	$ 15,600	$ 11,100	$ 6,300	$ 2,500	**$ 2,992,800**
Charge-offs	-	-	-	-	-	-	(5,546)	**(5,546)**
Recoveries	-	-	-	-	-	-	-	**-**
Provision for (recovery of) credit losses	93,200	(41,000)	1,000	15,200	(7,800)	(2,900)	4,346	**62,046**
Balance - December 31, 2016	$ 2,510,400	$ 453,500	$ 46,600	$ 30,800	$ 3,300	$ 3,400	$ 1,300	**$ 3,049,300**
Charge-offs	-	-	-	-	-	-	(22,769)	**(22,769)**
Recoveries	-	-	-	-	-	-	535	**535**
Provision for (recovery of) credit losses	190,700	(125,700)	(2,500)	1,500	(1,800)	(500)	22,334	**84,034**
Balance - December 31, 2017	$ 2,701,100	$ 327,800	$ 44,100	$ 32,300	$ 1,500	$ 2,900	$ 1,400	**$ 3,111,100**

The reserve for unfunded loan commitments is primarily related to undisbursed funds on construction loans and lines of credit. The Company evaluates credit risk associated with the loan portfolio at the same time it evaluates credit risk associated with the unfunded loan commitments. However, the reserves necessary for the commitments are reported separately in other liabilities in the accompanying consolidated balance sheets and not as part of the allowance for credit losses as presented above.

There were no loans considered to be impaired for the years ended and as of December 31, 2017 and December 31, 2016.

The Company manages asset quality and controls credit risk through diversification of the loan portfolio and the application of policies designed to promote sound underwriting and loan monitoring practices. The Company's senior management team is charged with monitoring asset quality, establishing credit policies and procedures, and enforcing the consistent application of these policies and procedures across the Company. Reviews of non-performing loans, past due loans, and larger credits are intended to identify potential charges to the allowance for credit losses and to determine the adequacy of the allowance, and are conducted on an ongoing basis. These reviews consider risk factors such as the financial strength of the borrowers, value of the applicable collateral, loan loss experience, estimated loan losses, growth in the loan portfolio, prevailing economic conditions, and other factors, which are collectively evaluated in order to determine if adjustments are necessary to the historical losses of each portfolio segment, the baseline for determining the allowance for credit losses.

The Company uses several credit quality indicators to manage credit risk. The Company's primary credit quality indicators are derived from an internal credit risk rating system that categorizes loans into pass, special mention, or classified categories. A credit risk rating is applied individually to each loan that has significant or unique credit characteristics that benefit from a case-by-case evaluation. The following are the definitions of the categories of the Company's internal credit risk rating:

- Pass: Loans in all classes that comprise the commercial and consumer portfolio segments that are not adversely rated, are contractually current as to principal and interest, and are otherwise in compliance with the contractual terms of the loan agreement. Management believes that there is a low likelihood of loss related to those loans that are considered pass.
- Special Mention: Loans classified as special mention have a potential weakness that deserves management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the loan or of the Company's credit position at some future date.
- Substandard: Loans classified as substandard are inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified have a well-defined weakness or weaknesses that jeopardize the repayment of the debt. They are characterized by the distinct possibility that the Company will sustain some loss if the deficiencies are not corrected.
- Doubtful/Loss: Loans classified as doubtful have all the weaknesses inherent in those classified as substandard, with the added characteristic that the weaknesses make collection or repayment in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable. The possibility of loss is extremely high, but because of certain important and reasonably specific pending factors, which may work towards strengthening of the asset, classification as a loss (and immediate charge off) is deferred until more exact status may be determined. In certain circumstances, a doubtful rating will be temporary, while the Company is awaiting an updated collateral valuation. In these cases, once the collateral is valued and appropriate margin applied, the remaining un-collateralized portion will be charged off. The remaining balance, properly margined, may then be upgraded to substandard but must remain on non-accrual. A loss rating is assigned to loans considered un-collectible and of such little value that the continuance as an active Company asset is not warranted. This rating does not mean that the loan has no recovery or salvage value but rather that the loan should be charged off now, even though partial or full recovery may be possible in the future.

Loans with classification of pass, special mention, substandard, and doubtful as of December 31, 2017 and 2016 are summarized as follows:

December 31, 2017	Pass	Special Mention	Substandard	Doubtful	Total
Residential mortgage loans — multi-family	$ 771,478,981	$ 624,096	$ -	$ -	**$ 772,103,077**
Residential mortgage loans — single family	132,825,834	-	-	-	**132,825,834**
Commercial loans	36,724,507	-	-	-	**36,724,507**
Construction loans	4,039,962	-	-	-	**4,039,962**
Land loans	750,000	-	-	-	**750,000**
Business banking loans	2,709,817	-	-	-	**2,709,817**
Consumer loans	475,577	-	-	-	**475,577**
Total	$ 949,004,678	$ 624,096	$ -	$ -	**$ 949,628,774**

December 31, 2016	Pass	Special Mention	Substandard	Doubtful	Total
Residential mortgage loans — multi-family	$ 702,197,482	$ -	$ 408,808	$ -	**$ 702,606,290**
Residential mortgage loans — single family	150,564,134	-	-	-	**150,564,134**
Commercial loans	37,809,060	-	196,313	-	**38,005,373**
Construction loans	1,304,489	-	-	-	**1,304,489**
Land loans	1,627,700	-	-	-	**1,627,700**
Business banking loans	2,748,080	-	-	-	**2,748,080**
Consumer loans	243,526	-	-	-	**243,526**
Total	$ 896,494,471	$ -	$ 605,121	$ -	**$ 897,099,592**

As of December 31, 2017, there was one loan for $227,997 past due 30-59 days, and all remaining loans were current. There was one loan for $186,500 past due 30-59 days as of December 31, 2016. There were no nonaccrual loans at December 31, 2017 and 2016.

In the ordinary course of business, the Company has granted loans to certain executive officers and directors and the companies with which they are associated. In management's opinion, such loans and commitments to lend were made under terms and prevailing interest rates that are consistent with the Company's normal lending policies. Interest income from loans to executive officers and directors was $423,662 and $346,993 during the years ending December 31, 2017 and 2016, respectively.

A summary of related-party loan activity for the years ended December 31, 2017 and 2016 is as follows:

	2017	2016
Beginning balance	**$ 8,970,490**	$ 9,177,486
Credit granted — including renewals	**3,379,684**	362,000
Repayments	**(1,661,081)**	(568,996)
Ending balance	**$ 10,689,093**	$ 8,970,490

3. BUILDING, OFFICE PROPERTIES, AND EQUIPMENT

Building, office properties, and equipment as of December 31, 2017 and 2016 are summarized as follows:

Description	2017	2016
Land	**$ 1,275,364**	$ 1,275,364
Building	**3,553,211**	3,553,211
Leasehold improvements	**1,877,559**	1,865,492
Equipment	**1,430,104**	1,612,716
Furniture and fixtures	**660,608**	658,369
Construction in progress	**-**	1,472
	8,796,846	8,966,624
Accumulated depreciation and amortization	**(4,117,120)**	(4,036,753)
Total	**$ 4,679,726**	$ 4,929,871

Depreciation and amortization expense for the years ended December 31, 2017 and 2016 was $303,237 and $299,047, respectively.

4. COMMITMENTS AND CONTINGENCIES

Off-Balance-Sheet Financial Instruments — The Company is a party to financial instruments with off-balance-sheet risk, in the normal course of business, to meet the financing needs of its customers. These financial

instruments include commitments to extend credit, standby letters of credit, and financial guarantees. The Company's maximum exposure to credit loss under standby letters of credit, financial guarantees, and commitments to extend credit is represented by the contractual amount of those instruments. The Company uses the same credit policies in making commitments and conditional obligations as it does for on-balance-sheet instruments.

The Company requires collateral to support financial instruments when it is deemed necessary. The Company evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained upon extension of credit is based on management's credit evaluation of the counterparty. Collateral held varies but generally includes real estate or deposits held in the Company.

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Some of the commitments are expected to expire without being drawn upon; the total commitment amounts do not necessarily represent future cash requirements. The Company had commitments to originate loans of $7.6 million and $13.1 million, undisbursed funds for construction loans of $2.3 million and $1.2 million, and undrawn lines of credit previously granted of approximately $26.4 million and $23.9 million at December 31, 2017 and 2016, respectively.

From time to time, the Company enters into certain types of contracts that contingently require the Company to indemnify parties against third-party claims and other obligations customarily indemnified in the ordinary course of the Company's business. The terms of such obligations vary, and generally, a maximum obligation is not explicitly stated. Therefore, the overall maximum amount of the obligations cannot be reasonably estimated. The most significant of these contracts relate to certain agreements with the Company's officers and directors under which the Company may be required to indemnify such persons for liabilities arising out of their performance of services for the Company. Historically, the Company has not been subject to indemnification claims and no liabilities have been recorded for these obligations on the balance sheet as of December 31, 2017 and 2016.

Collateralized standby letters of credit and financial guarantees written are conditional commitments issued by the Company to guarantee the performance of a customer to a third party. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. Management does not anticipate any material losses as a result of these transactions. There were no loan commitments collateralized by standby letters of credit and financial guarantees written at December 31, 2017. Loan commitments collateralized by standby letters of credit and financial guarantees written were $20,000 at December 31, 2016.

Leases — The Company leases office premises under operating leases that expire at various dates through September 24, 2022. Rental expense was $693,962 and $688,026 for the years ended December 31, 2017 and 2016, respectively. The projected minimum rental payments under the terms of the leases as of December 31, 2017 are as follows:

Years Ending December 31	
2018	$ 684,294
2019	442,378
2020	251,892
2021	190,224
2022	142,668
Total	$ 1,711,456

5. DEPOSITS

Deposit balances and the weighted-average interest rates for each category of deposits as of December 31, 2017 and 2016 are summarized as follows:

	2017		**2016**	
	Interest Rate	**Amount**	**Interest Rate**	**Amount**
Demand deposits	**- %**	**$ 116,795,273**	- %	$ 113,847,149
NOW accounts	**0.14**	**77,722,502**	0.13	76,402,688
Passbooks	**0.17**	**63,872,766**	0.16	53,590,129
Money market accounts	**0.26**	**232,338,664**	0.21	265,808,809
Certificates of deposit - less than $250,000	**0.87**	**123,287,697**	0.72	129,572,874
Certificates of deposit - $250,000 and over	**1.10**	**141,462,036**	0.57	113,928,450
Total	**0.45**	**$755,478,938**	0.31	$ 753,150,099

Certificates of deposit maturities as of December 31, 2017 are summarized as follows:

Years Ending December 31	
2018	$ 200,344,867
2019	22,905,753
2020	13,940,791
2021	13,725,265
2022	13,833,057
Total	$ 264,749,733

As of December 31, 2017 and 2016, the Company had certificates of deposit from the state of California Treasurer's Office of $90 million and $70 million, respectively.

In the ordinary course of business and as part of its normal banking activities, the Company has received deposits from certain directors, major shareholders and officers as well as entities with which these individuals are associated. These related parties had deposits at the Company of $4.3 million and $5.8 million at December 31, 2017 and 2016, respectively. Management believes these transactions were made on substantially the same terms, conditions, and prevailing interest rates as comparable transactions with other customers.

6. FHLB BORROWINGS

A primary additional funding source for the Company is a credit line with the FHLB of San Francisco of up to 50% of the Company's total assets. Interest is payable monthly at a weighted-average rate of 1.65% as of December 31, 2017. Average FHLB borrowings were $105.0 million and $94.0 million at a weighted-average interest rate of 1.72% and 2.53% in 2017 and 2016, respectively. The FHLB borrowings are collateralized by real estate loans (see Note 2) and the capital stock of the FHLB owned by the Company.

Maturities of FHLB borrowings as of December 31, 2017, are summarized as follows:

Years Ending December 31	
2018	$ 64,000,000
2019	25,000,000
2020	20,000,000
2021	10,000,000
2022	15,000,000
Thereafter	5,000,000
Total	$ 139,000,000

The Company also had a $4.2 million letter of credit with FHLB as collateral to secure a large local agency deposit at December 31, 2017 and 2016.

7. JUNIOR SUBORDINATED DEBENTURES

MFC has from time to time issued junior subordinated debentures related to concurrent issuances of trust-preferred securities by business trusts formed by MFC in order to generate regulatory capital for the Bank. This capital has a relatively low cost as interest payments on the debentures are deductible for income tax purposes. PVP Statutory Trust I, II, and III were formed by the Company for the sole purpose of issuing trust preferred securities. For financial reporting purposes, the Trusts are not consolidated, and the junior subordinated debentures held by the Trusts, issued and guaranteed by the Company, are reflected within the Company's consolidated balance sheets.

MFC's investment in the common trust securities of the trusts is included in other assets on its balance sheets. MFC has unconditionally guaranteed distributions on, and payments on liquidation and redemption of, all of these trust-preferred securities.

In June 2003, MFC issued $5,155,000 of junior subordinated debentures to PVP Statutory Trust I.

This trust purchased the debentures with the proceeds of the sale of its common trust securities to MFC for $155,000 and trust-preferred securities in a private placement for $5,000,000. The debentures and trust-preferred securities have generally identical terms, including that they mature in June 2033, have been redeemable at par at MFC's option since June 2008, and require quarterly distributions/interest payments at a fixed rate of 5.67% per annum through June 2008, and thereafter at a variable rate that adjusts quarterly at the three-month LIBOR rate plus 3.10%. The interest rate on the debentures was 4.77% per annum at December 31, 2017.

In January 2005, MFC issued $2,578,000 of junior subordinated debentures to PVP Statutory Trust II. This trust purchased the debentures with the proceeds of the sale of its common trust securities to MFC for $78,000 and trust-preferred securities in a private placement for $2,500,000. The debentures and trust-preferred securities have generally identical terms, including that they mature in March 2035, have been redeemable at par at MFC's option since March 2010, and require quarterly distributions/interest payments at a rate that adjusts quarterly at the three-month LIBOR rate plus 1.77%. The interest rate on the debentures was 3.36% per annum at December 31, 2017.

In January 2005, MFC issued $5,671,000 of junior subordinated debentures to PVP Statutory Trust III. This trust purchased the debentures with the proceeds of the sale of its common trust securities to MFC for $171,000 and trust-preferred securities in a private placement for $5,500,000. The debentures and trust-preferred securities have generally identical terms, including that they mature in March 2035, have been redeemable at par at MFC's option since March 2010, and require quarterly distributions/interest payments at a fixed rate of 5.67% through March 2010, and thereafter at a variable rate that adjusts quarterly at the three-month LIBOR rate plus 1.77%. The interest rate on the debentures was 3.36% per annum at December 31, 2017.

8. INCOME TAXES

A summary of income tax provision for the years ended December 31, 2017 and 2016 is as follows:

	2017	2016
Current:		
State	**$ 2,133,350**	$ 2,060,737
Federal	**6,090,452**	5,885,072
Total current	**8,223,802**	7,945,809
Deferred:		
State	**108,084**	41,822
Federal	**(481,993)**	221,108
Total deferred	**(373,909)**	262,930
Total	**$ 7,849,893**	$ 8,208,739

The components of the net deferred liability as of December 31, 2017 and 2016 are as follows:

	2017	2016
FEDERAL		
Deferred tax liabilities:		
Loan fees/costs	**$ (1,992,275)**	$ (3,142,102)
FHLB dividends	**(318,975)**	(531,625)
Depreciation	**(25,690)**	(9,163)
Other	**(200,897)**	(108,727)
Gross deferred tax liability	**(2,537,837)**	(3,791,617)
Deferred tax assets:		
California franchise tax	**632,243**	990,494
Depreciation	-	-
Bad debt and loan loss deduction	**669,172**	1,082,690
Other	**43,364**	43,382
Gross deferred tax asset	**1,344,779**	2,116,566
Net deferred tax liability	**$ (1,193,058)**	$ (1,675,051)

	2017	2016
STATE		
Deferred tax liabilities:		
Loan fees/costs	**$ (1,028,394)**	$ (973,154)
FHLB dividends	**(164,652)**	(164,652)
Depreciation	-	-
Other	**(103,702)**	(33,676)
Gross deferred tax liability	**(1,296,748)**	(1,171,482)
Deferred tax assets:		
California franchise tax	-	-
Depreciation	**52,544**	44,512
Bad debt and loan loss deduction	**345,420**	335,325
Other	**21,452**	22,397
Gross deferred tax asset	**419,416**	402,234
Net deferred tax liability	**$ (877,332)**	$ (769,248)

A reconciliation of total income tax expense for 2017 and 2016 to the expected tax expense computed by applying the statutory corporate income tax rate to pretax income for the years ended December 31, 2017 and 2016 is as follows:

	2017		2016	
	Amount	Percent	Amount	Percent
Tax expense at statutory rates	**$ 7,472,394**	**35%**	$ 6,918,825	35%
State franchise tax — net of federal benefit	**1,456,932**	**7**	1,366,663	7
Rate change	**(796,576)**	**(4)**		
Other	**(282,857)**	**(1)**	(76,749)	-
Total	**$ 7,849,893**	**37%**	$ 8,208,739	42%

9. REGULATORY CAPITAL

MFC and the Bank are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory – and possibly additional discretionary – actions by regulators that, if undertaken, could have a direct material effect on MFC's and the Bank's financial statements. Under capital adequacy guidelines, MFC and the Bank must meet specific capital adequacy guidelines that involve quantitative measures of MFC's and the Bank's assets, liabilities and certain off-balance-sheet items as calculated under regulatory accounting practices. MFC's and the Bank's capital classifications are also subject to qualitative judgments by the regulators about components, risk weightings and other factors.

Quantitative measures established by regulation to ensure capital adequacy require MFC and the Bank to maintain minimum amounts and ratios (set forth in the following table) of Tier 1 capital (as defined in the regulations) to total average assets (as defined), and minimum ratios of Tier 1, common equity Tier 1 and total capital (as defined) to risk-weighted assets (as defined). Management believes, as of December 31, 2017 and 2016, that MFC and the Bank met all regulatory capital requirements to which they were subject.

The Bank has been notified by the Office of the Comptroller of the Currency that, as of its most recent regulatory examination, the Bank is regarded as "well capitalized" under the regulatory framework for prompt corrective action. Such determination has been made based on the Bank's Tier 1, common equity Tier 1, total capital and leverage ratios. There have been no conditions or events since this notification that management believes would change the Bank's categorization as well capitalized under the ratios listed below:

MFC's and the Bank's capital amounts and ratios are substantially the same. The Bank's actual and required capital amounts and ratios are as follows:

	Actual		For Capital Adequacy Purposes		Applicable Federal Regulatory Requirements To Be Categorized As Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	**Ratio**	**Amount**	**Ratio**	**Amount**	**Ratio**
As of December 31, 2017:						
Tier 1 capital to average assets	$ 136,815,409	13.23%	$ 41,373,152	4.00%	$ 51,716,440	5.00%
Total capital to risk-weighted assets	139,979,710	24.18	46,307,972	8.00	57,884,965	10.00
Common Tier 1 capital to risk-weighted assets	136,815,409	23.64	26,048,234	4.50	37,625,227	6.50
Tier 1 capital to risk-weighted assets	136,815,409	23.64	34,730,979	6.00	46,307,972	8.00
As of December 31, 2016:						
Tier 1 capital to average assets	$ 127,912,266	12.85%	$ 39,809,389	4.00%	$ 49,761,737	5.00%
Total capital to risk-weighted assets	131,005,666	23.85	43,947,175	8.00	54,933,969	10.00
Common Tier 1 capital to risk-weighted assets	127,912,266	23.28	24,720,286	4.50	35,707,080	6.50
Tier 1 capital to risk-weighted assets	127,912,266	23.28	32,960,381	6.00	43,947,175	8.00

The Bank is required to establish and phase-in a "conservation buffer," consisting of a common equity Tier 1 capital amount equal to 2.5% of risk-weighted assets by 2019. As of December 31, 2017, the "conservation buffer" amount was 1.25% of risk-weighted assets. An institution that does not meet the conservation buffer requirement will be subject to restrictions on certain activities including payment of dividends, stock repurchases, and discretionary bonuses to executive officers. The phase-in began in 2016 and increases until fully phased-in by 2019.

Regulations of the FDIC do not permit the Bank to pay dividends on its common stock if its shareholders' equity would thereby be reduced below the Bank's regulatory capital requirements.

10. STOCK OPTION PLANS

MFC has one stock option plan, the 2017 Stock Option Plan ("2017 Plan"). The 2017 Plan authorizes MFC to issue to officers, directors, employees, and consultants of the Company up to 325,500 shares of common stock upon exercise of options. The exercise price of each option granted under the 2017 Plan may not be less than the fair market value of the common stock on the date of grant and the term of any option may not exceed 10 years. The 2017 Plan expires on December 31, 2026.

MFC had two stock option plans, the 2003 Stock Option Plan ("2003 Plan") and the 2007 Director Stock Option Plan ("2007 Director Plan"). The 2003 Plan authorized MFC to issue to officers, directors, employees, and consultants of the Company up to 348,115 shares of the common stock upon exercise of options. The exercise price of options granted under the 2003 Plan could not be less than the fair market value of the common stock on the date of grant and the term of any option could not exceed 10 years. The 2003 Stock Option Plan was replaced by the 2017 Plan in June 2017.

Under the 2007 Director Plan, MFC could issue up to 600,000 shares of common stock pursuant to automatic grants to each director on January 1 of each year of an option to purchase 9,200 shares of common stock. The exercise price of each option granted under the 2007 Director Plan was the fair market value of the common stock on the date the option was granted. Each option granted under the 2007 Director Plan vested one year from the date the option was granted and expired five years from the date of grant, subject to earlier termination if the optionee ceases to be a director. No options could be granted under the 2007 Director Plan after January 1, 2017. The 2007 Director Plan was replaced by the 2017 Plan in June 2017.

Stock-based compensation expense was $44,436 and $14,904 for 2017 and 2016, respectively, which decreased each year's income before taxes by such amount and its effect on basic and diluted EPS was negligible.

The status of shares subject to options and exercise prices during the year ended December 31, 2017 is as follows:

	Number of Options	Weighted–Average Exercise Price	Weighted-Average Remaining Contractual Life (Years)	Aggregate Intrinsic Value
Outstanding — beginning of year	227,430	$ 18.08		$ 2,615,445
Granted	67,620	24.90		316,462
Exercised	(77,280)	16.91		(978,806)
Outstanding — end of year	217,770	$ 20.61	2.29	$ 1,953,841
Vested and exercisable — year-end	150,150	$ 18.68	1.52	$ 1,637,057
Shares available	325,500			

The status of shares subject to options and exercise price during the year ended December 31, 2016, is as follows:

	Number of Options	Weighted–Average Exercise Price	Weighted-Average Remaining Contractual Life (Years)	Aggregate Intrinsic Value
Outstanding — beginning of year	237,090	$ 16.55		$ 2,204,937
Granted	67,620	21.17		316,462
Exercised	(67,620)	15.37		(708,658)
Canceled	(9,660)	21.17		(45,209)
Outstanding — end of year	227,430	$ 18.08	3.35	$ 1,767,550
Vested and exercisable — year-end	169,470	$ 17.02	2.78	$ 1,496,380
Shares available	450,065			

Information pertaining to options outstanding as of December 31, 2017 is as follows:

Range of Exercise Prices	Number Outstanding	Weighted–Average Remaining Contractual Life (Years)	Weighted–Average Exercise Price	Number Exercisable	Weighted–Average Exercise Price
$15.00–$18.99	82,530	0.77	$ 17.20	82,530	$ 17.20
$19.00–$25.00	135,240	3.22	22.69	67,620	20.47
Total	217,770	2.29	$ 20.61	150,150	$ 18.68

Certain information regarding options for the years ended December 31, 2017 and 2016 is as follows:

	2017	2016
Weighted-average fair value of stock options granted during the year	$ 1.23	$ 0.27
Total intrinsic value of options exercised	978,806	708,658
Total fair value of shares vested	15,649	125,194

As of December 31, 2017 and 2016, total unrecognized compensation costs related to options was less than $1.

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model with the following assumptions:

	2017	2016
Expected life (1)	5 year	5 year
Expected volatility (2)	11.15%	6.35%
Expected dividend yield (3)	3.87	4.09
Risk-free interest rate (4)	1.93	1.70

(1) The expected life is the vesting period of the option.
(2) The expected volatility was based on historical volatility for a period equal to the stock option's expected term.
(3) The expected dividend yield is based on the Company's prevailing dividend rate at the time of grant.
(4) The risk-free rate is based on the U.S. Treasury strips in effect at the time of grant equal to the stock option's expected term.

11. EARNINGS PER SHARE (EPS)

A reconciliation of the numerator and denominator of the basic and diluted EPS computation for the years ended December 31, 2017 and 2016 is as follows. For the years ended December 31, 2017 and 2016, the dilutive effect of all options outstanding is included in the determination of diluted EPS since there were no options outstanding with an exercise price which exceeded the average market price of the Company's common stock for those years.

On December 29, 2017, a 5% stock dividend was paid which increase the amount of shares outstanding by 310,782.

	2017			2016		
	Income (Numerator)	Shares (Denominator)	Per-Share Amount	Income (Numerator)	Shares (Denominator)	Per-Share Amount
Basic EPS						
Income available to common stockholders	$ 13,499,805	6,189,245	$ 2.18	$ 11,559,332	6,424,642	$ 1.80
Effect of Dilutive Securities						
Options — common stock equivalents		48,074	(0.02)		40,825	(0.01)
Diluted EPS						
Income available to common stockholders, plus assumed conversion	$ 13,499,805	6,237,319	$ 2.16	$ 11,559,332	6,465,467	$ 1.79

12. SUBSEQUENT EVENTS

The Company has evaluated subsequent events through February 15, 2018, which is the date the consolidated financial statements were available to be issued. There were no subsequent events that required disclosure in the consolidated financial statements.

REPORT OF INDEPENDENT AUDITORS

The Board of Directors and Stockholders of
Malaga Financial Corporation and Subsidiary

Report on the Financial Statements

We have audited the accompanying consolidated financial statements of Malaga Financial Corporation and its subsidiary (the "Company"), which comprise the consolidated balance sheets as of December 31, 2017 and 2016, and the related consolidated statements of operations, stockholders' equity and cash flows for the years then ended, and the related notes to the financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation and maintenance of internal control relevant to the preparation and fair presentation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Malaga Financial Corporation and its subsidiary as of December 31, 2017 and 2016, and the results of their operations and cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Moss Adams LLP

Los Angeles, California
February 15, 2018

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BOARD OF DIRECTORS

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Chairman of the Board

Raymond L. Craemer, M.D.*
Corporate Secretary

Randy C. Bowers*

Jerry A. Donahue*

Leo K. C. Lee*

Andrew C. T. Sheng, D.M.D.*

Doug Wible

CORPORATE ADMINISTRATION

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President / Chief Executive Officer

Jasna Penich*
Executive Vice President
Chief Financial Officer

Connie Begovich
Vice President
Deposit Compliance / BSA Officer

Mel Hashimoto
Vice President
Controller

Maureen Bray
Assistant Vice President
Marketing Coordinator

Sheree Carroll
Assistant Vice President
Security Officer

Gayle CdeBaca
Assistant Vice President
Facilities Manager

Rafael Vargas
Assistant Vice President
IT Manager

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Senior Vice President
Branch Administrator

Rose Mary Callahan
Vice President
Retail Banking Manager

Naher Elramly
Vice President
Branch Services Manager

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Vice President
Retail Operations

Brent Anderson
Assistant Vice President
Retail Banking Manager

Carmela Carroll
Assistant Vice President
Staff Auditor

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Senior Vice President
Loan Production Manager

Mark Smith
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John Tellenbach
Senior Vice President
Chief Credit Officer

Nina Brister
Vice President
Loan Service / Funding Manager

Cathy Jaramillo
Vice President
Loan Processing Manager

*Directors or Officers of MFC and Malaga Bank.

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Call any Branch Office TOLL-FREE 888-8-MALAGA. Call the Loan Center TOLL-FREE 888-3-MALAGA.
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MALAGA FINANCIAL CORPORATION

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