FARMERS & MERCHANTS BANCORP
Form 10-K
March 13, 2015

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, 2014

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE
SECURITIES EXCHANGE ACT OF 1934
For the transition period from _________ to __________.

Commission File Number: 000-26099

FARMERS & MERCHANTS BANCORP
(Exact name of registrant as specified in its charter)

Delaware	94-3327828
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
111 W. Pine Street, Lodi, California	95240
(Address of principal executive offices)	(Zip Code)

Registrant's telephone number, including area code (209) 367-2300

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

Securities registered pursuant to Section 12(g) of the Act: Common Stock, $0.01 Par Value Per Share

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

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

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

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

Indicate by check mark 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 or a smaller reporting company. See definition of “large accelerated filer,” “accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act (Check one):

Large accelerated filer	Accelerated filer	Non-accelerated filer (Do not check if a smaller reporting company)	Smaller Reporting Company

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

The aggregate market value of the Registrant's common stock held by non-affiliates on June 30, 2014 (based on the last reported trade on June 30, 2014) was $337,367,000.

The number of shares of Common Stock outstanding as of February 27, 2015: 785,782

Documents Incorporated by Reference:
Portions of the definitive Proxy Statement for the 2015 Annual Meeting of Stockholders to be filed with the Securities and Exchange Commission pursuant to Regulation 14A are incorporated by reference in Part III, Items 10 through 14.

FARMERS & MERCHANTS BANCORP
FORM 10-K

TABLE OF CONTENTS

Table of Contents

Introduction – Forward Looking Statements

This Form 10-K contains various forward-looking statements, usually containing the words “estimate,” “project,” “expect,” “objective,” “goal,” or similar expressions and includes assumptions concerning Farmers & Merchants Bancorp’s (together with its subsidiaries, the “Company” or “we”) operations, future results, and prospects. These forward-looking statements are based upon current expectations and are subject to risks and uncertainties. In connection with the “safe-harbor” provisions of the Private Securities Litigation Reform Act of 1995, the Company provides the following cautionary statement identifying important factors which could cause the actual results of events to differ materially from those set forth in or implied by the forward-looking statements and related assumptions.

Such factors include the following: (1) continuing economic sluggishness in the Central Valley of California; (2) significant changes in interest rates and prepayment speeds; (3) credit risks of lending and investment activities; (4) changes in federal and state banking laws or regulations; (5) competitive pressure in the banking industry; (6) changes in governmental fiscal or monetary policies; (7) uncertainty regarding the economic outlook resulting from the continuing war on terrorism, as well as actions taken or to be taken by the U.S. or other governments as a result of further acts or threats of terrorism; (8) ongoing drought conditions in California and the resulting impact on the Company’s agricultural customers; (9) expansion into new geographic markets and new lines of business; and (10) other factors discussed in Item 1A. Risk Factors.

Readers are cautioned not to place undue reliance on these forward-looking statements which speak only as of the date hereof. The Company undertakes no obligation to update any forward-looking statements to reflect events or circumstances arising after the date on which they are made.

PART I

Item 1. Business

General Development of the Business

August 1, 1916, marked the first day of business for Farmers & Merchants Bank. The Bank was incorporated under the laws of the State of California and licensed as a state-chartered bank. Farmers & Merchants’ first venture out of Lodi occurred when the Galt office opened in 1948. Since then the Bank has opened full-service branches in Linden, Modesto, Sacramento, Elk Grove, Turlock, Hilmar, Stockton, Merced, Walnut Creek and Irvine.

In addition to 24 full-service branches, the Bank serves the needs of its customers through a stand-alone ATM located on the grounds of the Lodi Grape Festival. In 2007, the Bank began offering certain products over the internet at www.fmbonline.com.

During 2014, the Bank began construction on a new facility to relocate our South Sacramento branch during the 1st quarter of 2015 and relocated our Crossroads branch to a new facility. Additionally, as part of our expansion into the greater San Francisco Bay Area, the Bank converted a loan production office in Walnut Creek into a full-service branch; and began construction on a new branch location in Concord that will open in the 1st half of 2015.

During 2014, the Bank also expanded its equipment leasing business, which was established in the 2nd quarter of 2013. The headquarters for this activity is located in our Irvine office, which was upgraded from a loan production office to a full-service branch office during 2014. See Item 7. “Management’s Discussion and Analysis of Financial Condition and Results of Operations – Financial Condition – Loans & Leases.”

On March 10, 1999, the Company, pursuant to a reorganization, acquired all of the voting stock of Farmers & Merchants Bank of Central California (the “Bank”). The Company is a bank holding company incorporated in the State of Delaware and registered under the Bank Holding Company Act of 1956, as amended. The Company's outstanding securities as of December 31, 2014, consisted of 784,082 shares of common stock, $0.01 par value and no shares of preferred stock issued. The Bank is the Company's principal asset.

Table of Contents

The Bank's two wholly owned subsidiaries are Farmers & Merchants Investment Corporation and Farmers/Merchants Corp. Farmers & Merchants Investment Corporation is currently dormant and Farmers/Merchants Corp. acts as trustee on deeds of trust originated by the Bank.

F & M Bancorp, Inc. was created in March 2002 to protect the name "F & M Bank." During 2002, the Company completed a fictitious name filing in California to begin using the streamlined name, "F & M Bank," as part of a larger effort to enhance the Company's image and build brand name recognition. Since 2002, the Company has converted all of its daily operating and image advertising to the "F & M Bank" name and the Company's logo, slogan and signage were redesigned to incorporate the trade name, "F & M Bank."

During 2003, the Company formed a wholly owned Connecticut statutory business trust, FMCB Statutory Trust I, for the sole purpose of issuing trust-preferred securities. See Note 13, located in "Item 8. Financial Statements and Supplementary Data."

The Company's principal business is to serve as a holding company for the Bank and for other banking or banking related subsidiaries, which the Company may establish or acquire. As a legal entity separate and distinct from its subsidiary, the Company's principal source of funds is, and will continue to be, dividends paid by and other funds from the Bank. Legal limitations are imposed on the amount of dividends that may be paid and loans that may be made by the Bank to the Company. See "Supervision and Regulation - Dividends and Other Transfer of Funds."

The Bank's deposit accounts are insured under the Federal Deposit Insurance Act up to applicable limits. See "Supervision and Regulation – Deposit Insurance."

As a bank holding company, the Company is subject to regulation and examination by the Board of Governors of the Federal Reserve System ("FRB"). The Bank is a California state-chartered non-FRB member bank subject to the regulation and examination of the California Department of Business Oversight ("DBO") and the Federal Deposit Insurance Corporation ("FDIC").

Service Area

During 2014, the Company continued its efforts to broaden its geographic footprint by converting loan production offices ("LPO") in Irvine, CA and Walnut Creek, CA to full-service branches. Experienced lending and equipment leasing professionals have been hired to staff these offices. Construction of an additional branch in Concord, an area contiguous to Walnut Creek, has also begun and should be completed during the 1st half of 2015. Both the Irvine and Walnut Creek areas have strong local economies, and will help diversify some of the concentration risks that the Company now has to the Central Valley and the agricultural industry. The Irvine location is also the headquarters for the Company's equipment leasing activities.

At the present time, the Company's primary service area remains the mid Central Valley of California, including Sacramento, San Joaquin, Stanislaus and Merced counties, where we operate 21 full-service branches and one stand-alone ATM. This area encompasses:

- Sacramento Metropolitan Statistical Area ("MSA"), with branches in Sacramento, Elk Grove and Galt. This MSA has a Population of 2.27 million and a Per Capita Income of approximately $49,700. The MSA includes significant employment in the following sectors: state and local government; agriculture; and trade, transportation and utilities. Unemployment currently stands at 6.3%.

- Stockton MSA, with branches in Lodi, Linden and Stockton. This MSA has a Population of 0.7 million and a Per Capita Income of approximately $37, 000. The MSA includes significant employment in the following sectors: state and local government; agriculture; trade, transportation, and utilities; and education and health services.

Unemployment currently stands at 10.2%.

- Modesto MSA, with branches in Modesto and Turlock. This MSA has a Population of 0.5 million and a Per Capita Income of approximately $38,400. The MSA includes significant employment in the following sectors: agriculture; trade, transportation and utilities; state and local government; and education and health services. Unemployment currently stands at 10.4%.

Table of Contents

- Merced MSA with branches in Hilmar and Merced. This MSA has a Population of 0.3 million and a Per Capita Income of approximately $34,000. The MSA includes significant employment in the following sectors: agriculture; state and local government; and trade, transportation and utilities. Unemployment currently stands at 12.1%.

All of the Company's Central Valley service areas are heavily influenced by the agricultural industry, however, with the exception of the State of California in the Sacramento MSA, no single employer represents a material concentration of jobs in any of our service areas.

See "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations – Overview" and "Financial Condition – Loans & Leases" for additional discussion regarding the Company's market conditions.

Through its network of banking offices, the Company emphasizes personalized service along with a broad range of banking services to businesses and individuals located in the service areas of its offices. Although the Company focuses on marketing its services to small and medium sized businesses, a broad range of retail banking services are made available to the local consumer market.

The Company offers a wide range of deposit instruments. These include checking, savings, money market, time certificates of deposit, individual retirement accounts and online banking services for both business and personal accounts.

The Company provides a broad complement of lending products, including commercial, real estate construction, agribusiness, consumer, credit card, real estate loans, and equipment leases. Commercial products include term loans, lines of credit and other working capital financing and letters of credit. Financing products for individuals include automobile financing, lines of credit, residential real estate, home improvement and home equity lines of credit.

The Company also offers a wide range of specialized services designed for the needs of its commercial accounts. These services include a credit card program for merchants, lockbox and other collection services, account reconciliation, investment sweep, on-line account access, and electronic funds transfers by way of domestic and international wire and automated clearinghouse.

The Company makes investment products available to customers, including mutual funds and annuities. These investment products are offered through a third party, which employs investment advisors to meet with and provide investment advice to the Company's customers.

Employees

At December 31, 2014, the Company employed 310 full time equivalent employees. The Company believes that its employee relations are satisfactory.

Competition

The banking and financial services industry in California generally, and in the Company's market areas specifically, is highly competitive. The increasingly competitive environment is a result primarily of changes in regulation, changes in technology and product delivery systems, and the accelerating pace of consolidation among financial service providers. The Company competes with other major commercial banks, diversified financial institutions, credit unions, savings and loan associations, money market and other mutual funds, mortgage companies, and a variety of other non-banking financial services and advisory companies. Federal legislation encourages competition between different types of financial service providers and has fostered new entrants into the financial services market. It is anticipated that this trend will continue. Using the financial holding company structure, insurance companies and securities firms may compete more directly with banks and bank holding companies.

5

Table of Contents

Many of our competitors are much larger in total assets and capitalization, have greater access to capital markets and offer a broader range of financial services than the Company. In order to compete with other financial service providers, the Company relies upon personal contact by its officers, directors, employees, and stockholders, along with various promotional activities and specialized services. In those instances where the Company is unable to accommodate a customer's needs, the Company may arrange for those services to be provided through its correspondents.

Government Policies

The Company's profitability, like most financial institutions, is primarily dependent on interest rate differentials. The difference between the interest rates paid by the Company on interest-bearing liabilities, such as deposits and other borrowings, and the interest rates received by the Company on its interest-earning assets, such as loans & leases extended to its customers and securities held in its investment portfolio, comprise the major portion of the Company's earnings. These rates are highly sensitive to many factors that are beyond the control of the Company and the Bank, such as inflation, recession and unemployment. The impact that changes in economic conditions might have on the Company and the Bank cannot be predicted.

The business of the Company is also influenced by the monetary and fiscal policies of the federal government and the policies of regulatory agencies, particularly the FRB. The FRB implements national monetary policies (with objectives such as curbing inflation and combating recession) through its open-market operations in U.S. Government securities by adjusting the required level of reserves for depository institutions subject to its reserve requirements, and by varying the target federal funds and discount rates applicable to borrowings by depository institutions. The actions of the FRB in these areas influence the growth of bank loans & leases, investments, and deposits and also affect interest rates earned on interest-earning assets and paid on interest-bearing liabilities. The nature and impact on the Company of any future changes in monetary and fiscal policies cannot be predicted.

From time to time, legislative acts, as well as regulations, are enacted which have the effect of increasing the cost of doing business, limiting or expanding permissible activities, or affecting the competitive balance between banks and other financial services providers. Proposals to change the laws and regulations governing the operations and taxation of banks, bank holding companies, and other financial institutions and financial services providers are frequently made in the U.S. Congress, in the state legislatures, and before various regulatory agencies. This legislation may change banking statutes and the operating environment of the Company and the Bank in substantial and unpredictable ways. If enacted, such legislation could increase or decrease the cost of doing business, limit or expand permissible activities or affect the competitive balance among banks, savings associations, credit unions, and other financial institutions. The Company cannot predict whether any of this potential legislation will be enacted, and if enacted, the effect that it, or any implemented regulations, would have on the financial condition or results of operations of the Company or any of its subsidiaries.

Supervision and Regulation

General

Bank holding companies and banks are extensively regulated under both federal and state law. The regulation is intended primarily for the protection of the banking system and the deposit insurance fund and not for the benefit of stockholders of the Company. Set forth below is a summary description of the material laws and regulations, which relate to the operations of the Company and the Bank. This description does not purport to be complete and is qualified in its entirety by reference to the applicable laws and regulations.

The Company

The Company is a registered bank holding company and is subject to regulation under the Bank Holding Company Act of 1956 ("BHCA"), as amended. Accordingly, the Company's operations are subject to extensive regulation and examination by the FRB. The Company is required to file with the FRB quarterly and annual reports and such additional information as the FRB may require pursuant to the BHCA. The FRB conducts periodic examinations of the Company.

The FRB may require that the Company terminate an activity or terminate control of or liquidate or divest certain subsidiaries of affiliates when the FRB believes the activity or the control of the subsidiary or affiliate constitutes a significant risk to the financial safety, soundness or stability of any of its banking subsidiaries. The FRB also has the authority to regulate provisions of certain bank holding company debt. Under certain circumstances, the Company must file written notice and obtain approval from the FRB prior to purchasing or redeeming its equity securities.

Table of Contents

Under the BHCA and regulations adopted by the FRB, a bank holding company and its non-banking subsidiaries are prohibited from requiring certain tie-in arrangements in connection with an extension of credit, lease or sale of property, or furnishing of services. For example, with certain exceptions, a bank may not condition an extension of credit on a promise by its customer to obtain other services provided by it, its holding company or other subsidiaries, or on a promise by its customer not to obtain other services from a competitor. In addition, federal law imposes certain restrictions on transactions between Farmers & Merchants Bancorp and its subsidiaries. Further, the Company is required by the FRB to maintain certain levels of capital. See “Capital Standards.”

The Company is prohibited by the BHCA, except in certain statutorily prescribed instances, from acquiring direct or indirect ownership or control of more than 5% of the outstanding voting shares of any company that is not a bank or bank holding company and from engaging directly or indirectly in activities other than those of banking, managing or controlling banks, or furnishing services to its subsidiaries. However, the Company, subject to the prior notice and/or approval of the FRB, may engage in any, or acquire shares of companies engaged in, activities that are deemed by the FRB to be so closely related to banking or managing or controlling banks as to be a proper incident thereto.

Under FRB regulations, a bank holding company is required to serve as a source of financial and managerial strength to its subsidiary banks and may not conduct its operations in an unsafe or unsound manner. In addition, it is the FRB’s policy that in serving as a source of strength to its subsidiary banks, a bank holding company should stand ready to use available resources to provide adequate capital funds to its subsidiary banks during periods of financial stress or adversity and should maintain the financial flexibility and capital-raising capacity to obtain additional resources for assisting its subsidiary banks. This support may be required at times when a bank holding company may not be able to provide such support. A bank holding company’s failure to meet its obligations to serve as a source of strength to its subsidiary banks will generally be considered by the FRB to be an unsafe and unsound banking practice or a violation of the FRB’s regulations or both.

The Company is not a financial holding company for purposes of the FRB.

The Company is also a bank holding company within the meaning of the California Financial Code. As such, the Company and its subsidiaries are subject to examination by, and may be required to file reports with, the DBO.

The Company’s securities are registered with the Securities and Exchange Commission under the Securities Exchange Act of 1934, as amended (the “Exchange Act”). As such, the Company is subject to the reporting, proxy solicitation and other requirements and restrictions of the Exchange Act.

The Bank

The Bank, as a California chartered non-FRB member bank, is subject to primary supervision, periodic examination and regulation by the DBO and the FDIC. If, as a result of an examination of the Bank, the FDIC should determine that the financial condition, capital resources, asset quality, earnings prospects, management, liquidity, or other aspects of the Bank’s operations are unsatisfactory, or that the Bank or its management is violating or has violated any law or regulation, various remedies are available to the FDIC. Such remedies include the power to enjoin “unsafe or unsound” practices, to require affirmative action to correct any conditions resulting from any violation or practice, to issue an administrative order that can be judicially enforced, to direct an increase in capital, to restrict the growth of the Bank, to assess civil monetary penalties, to remove officers and directors, and ultimately to terminate the Bank’s deposit insurance, which for a California chartered bank would result in a revocation of the Bank’s charter. The DBO has many of the same remedial powers.

Various requirements and restrictions under the laws of the State of California and the United States affect the operations of the Bank. State and federal statutes and regulations relate to many aspects of the Bank’s operations, including reserves against deposits, ownership of deposit accounts, interest rates payable on deposits, loans & leases, investments, mergers and acquisitions, borrowings, dividends, locations of branch offices, and capital requirements.

Further, the Bank is required to maintain certain levels of capital. See “Capital Standards.”

Table of Contents

The USA Patriot Act

Title III of the United and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (the "USA Patriot Act") includes numerous provisions for fighting international money laundering and blocking terrorism access to the U.S. financial system. The USA Patriot Act requires certain additional due diligence and record keeping practices, including, but not limited to, new customers, correspondent, and private banking accounts.

Part of the USA Patriot Act requires covered financial institutions to: (i) establish an anti-money laundering program; (ii) establish appropriate anti-money laundering policies, procedures and controls; (iii) appoint a Bank Secrecy Act officer responsible for day-to-day compliance; and (iv) conduct independent audits. The Patriot Act also expands penalties for violation of the anti-money laundering laws, including expanding the circumstances under which funds in a bank account may be forfeited. The Patriot Act also requires covered financial institutions to respond, under certain circumstances, to requests for information from federal banking agencies within 120 hours.

Privacy Restrictions

The Gramm-Leach-Bliley Act ("GLBA") requires financial institutions in the U.S. to provide certain privacy disclosures to customers and consumers, to comply with certain restrictions on the sharing and usage of personally identifiable information, and to implement and maintain commercially reasonable customer information safeguarding standards.

The Company believes that it complies with all provisions of the GLBA and all implementing regulations and the Bank has developed appropriate policies and procedures to meet its responsibilities in connection with the privacy provisions of GLBA.

Dividends and Other Transfer of Funds

Dividends from the Bank constitute the principal source of income to the Company. The Company is a legal entity separate and distinct from the Bank. The Bank is subject to various statutory and regulatory restrictions on its ability to pay dividends to the Company. Under such restrictions, the amount available for payment of dividends to the Company by the Bank totaled $45.8 million at December 31, 2014. During 2014, the Bank paid $8.0 million in dividends to the Company.

The FDIC and the DBO also have authority to prohibit the Bank from engaging in activities that, in their opinion, constitute unsafe or unsound practices in conducting its business. It is possible, depending upon the financial condition of the bank in question and other factors, that the FDIC or the DBO could assert that the payment of dividends or other payments might, under some circumstances, be an unsafe or unsound practice. Further, the FRB and the FDIC have established guidelines with respect to the maintenance of appropriate levels of capital by banks or bank holding companies under their jurisdiction. Compliance with the standards set forth in such guidelines and the restrictions that are or may be imposed under the prompt corrective action provisions of federal law could limit the amount of dividends that the Bank or the Company may pay. An insured depository institution is prohibited from paying management fees to any controlling persons or, with certain limited exceptions, making capital distributions if after such transaction the institution would be undercapitalized. The DBO may impose similar limitations on the Bank. See "Prompt Corrective Regulatory Action and Other Enforcement Mechanisms" and "Capital Standards" for a discussion of these additional restrictions on capital distributions.

Transactions with Affiliates

The Bank is subject to certain restrictions imposed by federal law on any extensions of credit to, or the issuance of a guarantee or letter of credit on behalf of the Company or other affiliates, the purchase of, or investments in stock or other securities thereof, the taking of such securities as collateral for loans & leases, and the purchase of assets of the Company or other affiliates. Such restrictions prevent the Company and other affiliates from borrowing from the Bank unless the loans are secured by marketable obligations of designated amounts. Further, such secured loans and investments by the Bank to or in the Company or to or in any other affiliates are limited, individually, to 10% of the

Bank's capital and surplus (as defined by federal regulations), and such secured loans and investments are limited, in the aggregate, to 20% of the Bank's capital and surplus (as defined by federal regulations).

Table of Contents
In addition, the Company and its operating subsidiaries generally may not purchase a low-quality asset from an affiliate, and other specified transactions between the Company or its operating subsidiaries and an affiliate must be on terms and conditions that are consistent with safe and sound banking practices.

Also, the Company and its operating subsidiaries may engage in transactions with affiliates only on terms and under conditions that are substantially the same, or at least as favorable to the Company or its subsidiaries, as those prevailing at the time for comparable transactions with (or that in good faith would be offered to) non-affiliated companies.

California law also imposes certain restrictions with respect to transactions with affiliates. Additionally, limitations involving the transactions with affiliates may be imposed on the Bank under the prompt corrective action provisions of federal law. See “Prompt Corrective Action and Other Enforcement Mechanisms.”

Capital Standards
The FRB and the FDIC have established risk-based capital guidelines with respect to the maintenance of appropriate levels of capital by United States banking organizations. These guidelines are intended to provide a measure of capital that reflects the risk associated with a banking organization’s operations for both transactions reported on the balance sheet as assets and transactions, such as letters of credit and recourse arrangements, which are recorded as off balance sheet items. Under these guidelines, nominal dollar amounts of assets and credit equivalent amounts of off balance sheet items are multiplied by one of several risk adjustment percentages, which range from 0% for assets with low credit risk, such as certain U.S. Treasury securities, to 100% for assets with relatively high credit risk, such as commercial loans.

The federal banking agencies currently require a minimum ratio of qualifying total capital to risk-weighted assets of 8% and a minimum ratio of Tier 1 capital to risk-weighted assets of 4%. In addition to the risk-based guidelines, federal banking regulators require banking organizations to maintain a minimum amount of Tier 1 capital to total assets, referred to as the leverage ratio. For a banking organization rated in the highest of the five categories used by regulators to rate banking organizations, the minimum leverage ratio of Tier 1 capital to total assets must be 4%. In addition to these uniform risk-based capital guidelines and leverage ratios that apply across the industry, the regulators have the discretion to set individual minimum capital requirements for specific institutions at rates significantly above minimum guidelines and ratios. For further information on the Company and the Bank’s risk-based capital ratios see Note 14 located in “Item 8. Financial Statements and Supplementary Data.”

In 2013, both the FRB and the FDIC approved final rules that substantially amend the regulatory risk-based capital rules applicable to the Company and the Bank. These rules implement the Basel III regulatory capital reforms and changes required by the Dodd-Frank Act as hereinafter defined.

The final rules include new minimum risk-based capital and leverage ratios, which would be phased in over time. The new minimum capital level requirements applicable to the Company and the Bank under the final rules will be: (i) a common equity Tier 1 capital ratio of 4.5% of risk-weighted assets (“RWA”); (ii) a Tier 1 capital ratio of 6% of RWA; (iii) a total capital ratio of 8% of RWA; and (iv) a Tier 1 leverage ratio of 4% of total assets. The final rules also establish a "capital conservation buffer" of 2.5% above each of the new regulatory minimum capital ratios, which would result in the following minimum ratios: (i) a common equity Tier 1 capital ratio of 7.0% of RWA; (ii) a Tier 1 capital ratio of 8.5% of RWA; and (iii) a total capital ratio of 10.5% of RWA. An institution will be subject to limitations on paying dividends, engaging in share repurchases, and paying discretionary bonuses if its capital level falls below the buffer amount. The final rules also permit the Company’s subordinated debentures issued in 2003 to continue to be counted as Tier 1 capital.

The final rules became effective as applied to the Company and the Bank on January 1, 2015, with a phase in period through January 1, 2019. The Company believes that it is currently in compliance with all of these new capital requirements (as fully phased-in) and that they will not result in any restrictions on the Company's business activity.

Table of Contents

Prompt Corrective Action and Other Enforcement Mechanisms

The Federal Deposit Insurance Corporation Improvement Act of 1991 (“FDICIA”), among other things, identifies five capital categories for insured depository institutions (well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized and critically undercapitalized) and requires the respective Federal regulatory agencies to implement systems for “prompt corrective action” for insured depository institutions that do not meet minimum capital requirements within such categories. FDICIA imposes progressively more restrictive constraints on operations, management, and capital distributions, depending on the category in which an institution is classified. Failure to meet the capital guidelines could also subject a banking institution to capital raising requirements. An “undercapitalized” institution must develop a capital restoration plan. At December 31, 2014, the Bank exceeded all of the required ratios for classification as “well capitalized.” It should be noted; however, that the Bank’s capital category is determined solely for the purpose of applying the federal banking agencies’ prompt corrective action regulations and the capital category may not constitute an accurate representation of the Bank’s overall financial condition or prospects.

An institution that, based upon its capital levels, is classified as well capitalized, adequately capitalized, or undercapitalized may be treated as though it were in the next lower capital category if the appropriate federal banking agency, after notice and opportunity for hearing, determines that an unsafe or unsound condition or practice warrants such treatment. At each successive lower capital category, an insured depository institution is subject to more restrictions.

Banking agencies have also adopted regulations which mandate that regulators take into consideration: (i) concentrations of credit risk; (ii) interest rate risk (when the interest rate sensitivity of an institution’s assets does not match the sensitivity of its liabilities or its off-balance-sheet position); and (iii) risks from non-traditional activities, as well as an institution’s ability to manage those risks, when determining the adequacy of an institution’s capital. That evaluation will be made as a part of the institution’s regular safety and soundness examination. In addition, the banking agencies have amended their regulatory capital guidelines to incorporate a measure for market risk. In accordance with the amended guidelines, any company with significant trading activity must incorporate a measure for market risk in its regulatory capital calculations.

In addition to measures taken under the prompt corrective action provisions, commercial banking organizations may be subject to potential enforcement actions by the federal banking agencies for unsafe or unsound practices in conducting their businesses or for violations of any law, rule, regulation, any condition imposed in writing by the agency, or any written agreement with the agency. Enforcement actions may include the imposition of a conservator or receiver, the issuance of a cease-and-desist order that can be judicially enforced, the termination of insurance of deposits (in the case of a depository institution), the imposition of civil money penalties, the issuance of directives to increase capital, the issuance of formal and informal agreements, the issuance of removal and prohibition orders against institution-affiliated parties and the enforcement of such actions through injunctions or restraining orders based upon a judicial determination that the agency would be harmed if such equitable relief was not granted. Additionally, a holding company's inability to serve as a source of strength to its subsidiary banking organizations could serve as an additional basis for a regulatory action against the holding company.

Federal banking regulators have also issued final guidance regarding commercial real estate (“CRE”) lending. This guidance suggests that institutions that are potentially exposed to significant CRE concentration risk will be subject to increased regulatory scrutiny. Institutions that have experienced rapid growth in CRE lending, have notable exposure to a specific type of CRE lending, or are approaching or exceed certain supervisory criteria that measure an institution’s CRE portfolio against its capital levels, may be subject to such increased regulatory scrutiny. The Company’s CRE portfolio may be viewed as falling within one or more of the foregoing categories, and accordingly may become subject to increased regulatory scrutiny because of the CRE portfolio. Institutions that are determined by their regulator to have an undue concentration in CRE lending may be required to maintain levels of capital in excess of the statutory minimum requirements and/or be required to reduce their concentration in CRE loans. The FDIC has determined that the Company does not have any undue concentrations in CRE lending.

Safety and Soundness Standards

The federal banking agencies have adopted guidelines designed to assist in identifying and addressing potential safety and soundness concerns before capital becomes impaired. The guidelines set forth operational and managerial standards relating to: (i) internal controls, information systems, and internal audit systems; (ii) loan & lease documentation; (iii) credit underwriting; (iv) asset growth; (v) earnings; and (vi) compensation, fees, and benefits. In addition, the federal banking agencies have also adopted safety and soundness guidelines with respect to asset quality and earnings standards. These guidelines provide six standards for establishing and maintaining a system to identify problem assets and prevent those assets from deteriorating. Under these standards, any insured depository institution should: (i) conduct periodic asset quality reviews to identify problem assets; (ii) estimate the inherent losses in problem assets and establish reserves that are sufficient to absorb estimated losses; (iii) compare problem asset totals to capital; (iv) take appropriate corrective action to resolve problem assets; (v) consider the size and potential risks of material asset concentrations; and (vi) provide periodic asset quality reports with adequate information for management and the Board of Directors to assess the level of asset risk. These guidelines also set forth standards for evaluating and monitoring earnings and for ensuring that earnings are sufficient for the maintenance of adequate capital and reserves.

Table of Contents

Deposit Insurance

After the passage of the Dodd-Frank Act, the deposits of the Bank are now insured by the FDIC up to $250,000 per insured depositor.

The Federal Deposit Insurance Reform Act of 2005 provided the FDIC Board of Directors the authority to set the designated reserve ratio for the Deposit Insurance Fund ("DIF") between 1.15% and 1.50%. The FDIC must adopt a restoration plan when the reserve ratio falls below 1.15% and begin paying dividends when the reserve ratio exceeds 1.35%.

Under the Dodd-Frank Act, the minimum designated reserve ratio of the DIF increased from 1.15% to 1.35% of estimated insured deposits. Additionally, the Dodd-Frank Act revised the assessment base against which an insured depository institution's deposit insurance premiums paid to the DIF will be calculated. On February 7, 2011, the FDIC approved a final rule, as mandated by Dodd-Frank, changing the deposit insurance assessment system from one that is based on total domestic deposits to one that is based on average consolidated total assets minus average tangible equity. The new rule took effect for the quarter beginning April 1, 2011.

The Bank's FDIC premiums were $1.0 million in 2014 compared to $981,000 in 2013. Future increases in insurance premiums could have adverse effects on the operating expenses and results of operations of the Company. Management cannot predict what insurance assessment rates will be in the future.

Insurance of deposits may be terminated by the FDIC upon a finding that the institution has engaged in unsafe or unsound practices, is in an unsafe or unsound condition to continue operations, or has violated any applicable law, regulation, rule, order, or condition imposed by the FDIC or the Bank's primary regulator. Management of the Company is not aware of any practice, condition or violation that might lead to termination of the Company's deposit insurance.

Community Reinvestment Act ("CRA") and Fair Lending

The Bank is subject to certain fair lending requirements involving lending, investing, and other CRA activities. CRA requires each insured depository institution to identify the communities served by the institution's offices and to identify the types of credit and investments the institution is prepared to extend within such communities including low and moderate-income neighborhoods. It also requires the institution's regulators to assess the institution's performance in meeting the credit needs of its community and to take such assessment into consideration in reviewing applications for mergers, acquisitions, relocation of existing branches, opening of new branches, and other transactions. A bank may be subject to substantial penalties and corrective measures for a violation of certain fair lending laws.

Table of Contents

A bank’s compliance with the Community Reinvestment Act is assessed using an evaluation system, which bases CRA ratings on an institution’s lending, service and investment performance. An unsatisfactory rating may be the basis for denying a merger application. The Bank’s latest CRA examination was completed by the Federal Deposit Insurance Corporation in September 2013 and the Bank received an overall Outstanding rating in complying with its CRA obligations.

Consumer Protection Regulations

The Company’s lending activities are subject to a variety of statutes and regulations designed to protect consumers, including the Fair Credit Reporting Act, Equal Credit Opportunity Act, the Fair Housing Act, the Truth-in-Lending Act, the Unfair, Deceptive or Abusive Acts and Practices and the Dodd-Frank Act. Deposit operations are also subject to laws and regulations that protect consumer rights including Funds Availability, Truth in Savings, and Electronic Funds Transfers. Additional rules govern check writing ability on certain interest earning accounts and prescribe procedures for complying with administrative subpoenas of financial records. Additionally, effective October 26, 2013, there is a new provision of the Federal Reserve Regulation E to accommodate the new Remittance Transfer Rule requirement of the Dodd-Frank Act concerning international wires.

The Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”)

On July 21, 2010, President Obama signed into law the sweeping financial regulatory reform, Dodd-Frank Act, that implements significant changes to the regulation of the financial services industry, including provisions that, among other things:

- Centralize responsibility for consumer financial protection by creating a new agency within the Federal Reserve Board, the Bureau of Consumer Financial Protection, with broad rulemaking, supervision and enforcement authority for a wide range of consumer protection laws that would apply to all banks and thrifts.

- Apply the same leverage and risk-based capital requirements that apply to insured depository institutions to bank holding companies.

- Require the FDIC to seek to make its capital requirements for banks countercyclical so that the amount of capital required to be maintained increases in times of economic expansion and decreases in times of economic contraction.

- Change the assessment base for federal deposit insurance from the amount of insured deposits to consolidated assets less tangible capital.

- Implement corporate governance revisions, including executive compensation and proxy access by stockholders.

- Make permanent the $250,000 limit for federal deposit insurance and increase the cash limit of Securities Investor Protection Corporation protection from $100,000 to $250,000, and provide unlimited federal deposit insurance until January 1, 2013 for non-interest bearing demand transaction accounts at all insured depository institutions.

- Repeal the federal prohibitions on the payment of interest on demand deposits effective July 21, 2011, thereby permitting depository institutions to pay interest on business transaction and other accounts.

Many aspects of the Dodd-Frank Act are subject to rulemaking by various regulatory agencies and will take effect over several years, making it difficult to anticipate the overall financial impact on the Company, its customers or the financial industry more generally. The elimination of the prohibition on the payment of interest on demand deposits could materially increase our interest expense, depending on our competitors' responses.

Notice and Approval Requirements Related to Control

Banking laws impose notice, approval and ongoing regulatory requirements on any shareholder or other party that seeks to acquire direct or indirect "control" of an FDIC-insured depository institution. These laws include the BHCA and the Change in Bank Control Act. Among other things, these laws require regulatory filings by a shareholder or other party that seeks to acquire direct or indirect "control" of an FDIC-insured depository institution or bank holding company. The determination whether an investor "controls" a depository institution is based on all of the facts and circumstances surrounding the investment. As a general matter, a party is deemed to control a depository institution or other company if the party owns or controls 25% or more of any class of voting stock. Subject to rebuttal, a party may be presumed to control a depository institution or other company if the investor owns or controls 10% or more of any class of voting stock. Ownership by family members, affiliated parties, or parties acting in concert, is typically aggregated for these purposes. If a party's ownership of the Company were to exceed certain thresholds, the investor could be deemed to "control" the Company for regulatory purposes. This could subject the investor to regulatory filings or other regulatory consequences.

In addition, except under limited circumstances, bank holding companies are prohibited from acquiring, without prior approval:

Table of Contents

- control of any other bank or bank holding company or all or substantially all the assets thereof; or
- more than 5% of the voting shares of a bank or bank holding company which is not already a subsidiary.

Incentive Compensation

The Dodd-Frank Act requires the federal bank regulators and the SEC to establish joint regulations or guidelines prohibiting incentive-based payment arrangements at specified regulated entities, including the Company and the Bank, having at least $1 billion in total assets that encourage inappropriate risks by providing an executive officer, employee, director or principal stockholder with excessive compensation, fees, or benefits or that could lead to material financial loss to the entity. In addition, these regulators must establish regulations or guidelines requiring enhanced disclosure to regulators of incentive-based compensation arrangements. The agencies proposed such regulations in April 2011, but the regulations have not been finalized. If the regulations are adopted in the form initially proposed, they will impose limitations on the manner in which the Company may structure compensation for our executives.

The FRB will review, as part of the regular, risk-focused examination process, the incentive compensation arrangements of banking organizations that are not "large, complex banking organizations." These reviews will be tailored to each organization based on the scope and complexity of the organization's activities and the prevalence of incentive compensation arrangements. The findings of the supervisory initiatives will be included in reports of examination. Deficiencies will be incorporated into the organization's supervisory ratings, which can affect the organization's ability to make acquisitions and take other actions. Enforcement actions may be taken against a banking organization if its incentive compensation arrangements, or related risk management control or governance processes, pose a risk to the organization's safety and soundness and the organization is not taking prompt and effective measures to correct the deficiencies.

Future Legislation and Regulatory Initiatives

Various legislative and regulatory initiatives are from time to time introduced in Congress and state legislatures, as well as regulatory agencies. Future legislation regarding financial institutions may change banking statutes and the operating environment of the Company and the Bank in substantial and unpredictable ways, and could increase or decrease the cost of doing business, limit or expand permissible activities or affect the competitive balance depending upon whether any of this potential legislation will be enacted, and if enacted, the effect that it or any implementing regulations, would have on the financial condition or results of operations of the Company or the Bank. The nature and extent of future legislative and regulatory changes affecting financial institutions is unpredictable at this time. The Company cannot determine the ultimate effect that such potential legislation, if enacted, would have upon its financial condition or operations.

Available Information

Company reports filed with the SEC including the annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, proxy statements and ownership reports filed by directors, executive officers and principal stockholders can be accessed through the Company's website at http://www.fmbonline.com. The link to the SEC is on the About Us page.

Item 1A. Risk Factors

An investment in our common stock is subject to risks inherent in our business. The material risks and uncertainties that management believes may affect our business are described below. Before making an investment decision, you should carefully consider the risks and uncertainties described below together with all of the other information included or incorporated by reference in this 10-K Report. The risks and uncertainties described below are not the only ones facing our business. Additional risks and uncertainties that management is not aware of or focused on or that management currently deems immaterial may also impair our business operations. This 10-K Report is qualified in its entirety by these risk factors.

If any of the following risks actually occur, our financial condition and results of operations could be materially and adversely affected. If this were to happen, the value of our common stock could decline significantly, and you could lose all or part of your investment.

Risks Associated With Our Business

Continuing Difficult Economic Conditions In Our Service Areas Could Adversely Affect Our Operations And/Or Cause Us To Sustain Losses - While the national economy and the economy of other portions of California have experienced improvements over the past several years, the Central Valley of California, which remains the Company's primary market area, continues to experience sluggish economic conditions. This is reflected in: (1) continuing public sector financial stress, both at the local and statewide level. See "Item 1. Business – Service Area." The State of California, a large employer in one of the Company's market territories, continues to experience financial challenges, particularly relating to the funding of pension and other financial commitments made to retired employees, and the City of Stockton, which recently exited bankruptcy but still faces financial challenges; and (2) continuing high levels of unemployment and home prices that have only slightly improved and remain well below peak levels.

Although we have initiated efforts to broaden our geographic footprint, our retail and commercial banking operations remain concentrated in Sacramento, San Joaquin, Stanislaus and Merced Counties. See "Item 1. Business – Service Area." As a result of this geographic concentration, our results of operations depend largely upon economic conditions in these areas. Whereas much of this area appears to have stabilized, real estate values remain well below peak prices and unemployment remains well above most other areas in the state and country. As a result, risk still remains from the possibility that losses will be sustained if a significant number of our borrowers, guarantors and related parties fail to perform in accordance with the terms of their loans or leases. We have adopted underwriting and credit monitoring procedures and credit policies, including the establishment and review of the allowance for credit losses, that management believes are appropriate to minimize this risk by assessing the likelihood of nonperformance, tracking loan & lease performance and diversifying our credit portfolio. These policies and procedures; however, may not prevent unexpected losses that could materially adversely affect our results of operations in general and the market value of our stock. See "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations – Overview - Looking Forward: 2015 and Beyond."

Additionally, despite the stability of our earnings over the last several years, economic uncertainties may continue for the foreseeable future and the full extent of the repercussions on our local economies in general and our business in particular are not fully known at this time. Such events may have a negative effect on: (i) our ability to service our existing customers and attract new customers; (ii) the ability of our borrowers to operate their business as successfully as in the past; (iii) the financial security and net worth of our customers; and (iv) the ability of our customers to repay their loans or leases with us in accordance with the terms thereof.

Our Allowance For Credit Losses May Not Be Adequate To Cover Actual Losses - A significant source of risk arises from the possibility that losses could be sustained because borrowers, guarantors, and related parties may fail to perform in accordance with the terms of their loans & leases. The underwriting and credit monitoring policies and procedures that we have adopted to address this risk may not prevent unexpected losses that could have a material adverse effect on our business, financial condition, results of operations and cash flows. Unexpected losses may arise from a wide variety of specific or systemic factors, many of which are beyond our ability to predict, influence, or control.

Like all financial institutions, we maintain an allowance for credit losses to provide for loan & lease defaults and non-performance. See "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations – Provision and Allowance for Credit Losses." The allowance is funded from a provision for credit losses, which is a charge to our income statement. Our allowance for credit losses may not be adequate to cover actual loan & lease losses, and future provisions for credit losses could materially and adversely affect our business, financial condition, results of operations and cash flows. The allowance for credit losses reflects our estimate of the probable losses in our loan & lease portfolio at the relevant balance sheet date. Our allowance for credit losses is based on prior experience, as well as an evaluation of the known risks in the current portfolio, composition and growth of the loan & lease portfolio and other economic factors. The determination of an appropriate level of credit loss allowance is an inherently difficult process and is based on numerous assumptions. The amount of future losses is susceptible to changes in economic, operating and other conditions, including changes in interest rates, that may be beyond our control and these losses may exceed current estimates.

Table of Contents

The process we use to estimate losses inherent in our credit exposure requires difficult, subjective and complex judgments, including forecasts of economic conditions and how these economic conditions might impair the ability of our borrowers to repay their loans and lessees to make their lease payments. The level of uncertainty concerning current economic conditions may adversely affect the accuracy of our estimates, which may, in turn, impact the reliability of the allowance for credit losses.

While we believe that our allowance for credit losses is adequate to cover current losses, we cannot assure you that we will not increase the allowance for credit losses further or that regulators will not require us to increase this allowance. Either of these occurrences could materially adversely affect our business, financial condition, results of operations and cash flows.

We Are Dependent On Real Estate And Further Downturns In The Real Estate Market Could Hurt Our Business - Although our regulators have determined that we do not have significant CRE concentration risk, a significant portion of our loan portfolio is dependent on real estate. See “Item 1. Business – Supervision and Regulation - Prompt Corrective Action and Other Enforcement Mechanisms.” At December 31, 2014, real estate served as the principal source of collateral with respect to approximately 67% of our loan outstandings and 19% of loans outstanding were secured by production agricultural properties. Continuing stresses in current economic conditions in our local markets or rising interest rates could have an adverse effect on the demand for new loans, the ability of borrowers to repay outstanding loans, the value of real estate and other collateral securing loans and the value of real estate owned by us, as well as our financial condition and results of operations in general and the market value of our common stock.

Acts of nature, including earthquakes, floods and fires, which may cause uninsured damage and other loss of value to real estate that secures these loans, may also negatively impact our financial condition.

Our Real Estate Lending Also Exposes Us To The Risk Of Environmental Liabilities - In the course of our business, we may foreclose and take title to real estate, and could be subject to environmental liabilities with respect to these properties. We may be held liable to a governmental entity or to third persons 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, as 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. If we ever become subject to significant environmental liabilities, our business, financial condition, liquidity and results of operations could be materially and adversely affected.

Our Business Is Subject To Interest Rate Risk And Changes In Interest Rates May Adversely Affect Our Performance And Financial Condition - Our earnings are impacted by changing interest rates. Changes in interest rates impact the demand for new loans & leases, the credit profile of our borrowers, the rates received on loans & leases and securities and rates paid on deposits and borrowings. The difference between the rates received on loans & leases and securities and the rates paid on deposits and borrowings is known as the net interest margin. Like many financial institutions, our net interest margin has been declining. We expect that continued low interest rates and aggressive competitor pricing strategies will continue to push net interest margin lower in 2015.

Although we believe our current level of interest rate sensitivity is reasonable, significant fluctuations in interest rates and increasing competition may have an adverse effect on our business, financial condition and results of operations. See “Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations – Net Interest Income/Net Interest Margin” and “Item 7A. Quantitative and Qualitative Disclosures About Market Risk - Interest Rate Risk.”

Table of Contents

Continuing low levels of market interest rates could adversely affect our earnings. The FRB regulates the supply of money and credit in the United States. Its policies determine, in large part, the cost of funds for lending and investing and the yield earned on those loans, leases and investments, which impact the Company's net interest margin. Beginning in September 2007 the FRB implemented a series of rate reductions in response to the current state of the national economy and housing market as well as the volatility of financial markets. Rates have remained low ever since, and show no signs of significantly increasing in the near future. When interest rates decline, borrowers tend to refinance higher-rate, fixed-rate loans at lower rates, and prepaying their existing loans. Under those circumstances, we would not be able to reinvest those prepayments in assets earning interest rates as high as the rates on the prepaid loans. In addition, our CRE and commercial loans, which carry interest rates that, in general, adjust in accordance with changes in the prime rate, will adjust to lower rates. We are also significantly affected by the level of loan & lease demand available in our market. The inability to make sufficient loans & leases directly affects the interest income we earn. Lower loan & lease demand will generally result in lower interest income realized as we place funds in lower yielding investments. See "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations – Overview - Looking Forward: 2015 and Beyond."

Our Accounting Estimates and Risk Management Processes Rely On Analytical and Forecasting Models - The processes we use to measure the fair value of financial instruments, as well as the processes used to estimate the effects of changing interest rates and other market measures on our financial condition and results of operations, depends upon the use of analytical and forecasting models. These models reflect assumptions that may not be accurate, particularly in times of market stress or other unforeseen circumstances. Even if these assumptions are adequate, the models may prove to be inadequate or inaccurate because of other flaws in their design or their implementation. If the models we use for interest rate risk and asset-liability management are inadequate, we may incur increased or unexpected losses upon changes in market interest rates or other market measures. If the models we use to measure the fair value of financial instruments are inadequate, the fair value of such financial instruments may fluctuate unexpectedly or may not accurately reflect what we could realize upon sale or settlement of such financial instruments. Any such failure in our analytical or forecasting models could have a material adverse effect on our business, financial condition and results of operations.

Failure To Successfully Execute Our Strategy Could Adversely Affect Our Performance - Our financial performance and profitability depends on our ability to execute our corporate growth strategy. Continued growth however, may present operating and other problems that could adversely affect our business, financial condition and results of operations. Accordingly, there can be no assurance that we will be able to execute our growth strategy or maintain the level of profitability that we have recently experienced. Factors that may adversely affect our ability to attain our long-term financial performance goals include those stated elsewhere in this section, as well as the:

- inability to maintain or increase net interest margin;
- inability to control non-interest expense, including, but not limited to, rising employee and healthcare costs and the costs of regulatory compliance;
- inability to maintain or increase non-interest income; and
- continuing ability to expand through de novo branching or otherwise.

New Market Areas And New Lines Of Business Or New Products And Services May Subject Us To Additional Risks. A Failure To Successfully Manage These Risks May Have A Material Adverse Effect On Our Business - As part of our growth strategy, we have implemented and may continue to implement new market areas and new lines of business. We recently have begun to implement plans to (i) expand into the greater San Francisco Bay Area, which is a new market area for us, and (ii) introduce equipment leasing as a new product line. There are risks and uncertainties associated with these efforts, particularly in instances where such product lines are not fully mature. In developing and marketing new lines of business and/or new products and services and/or shifting the focus of our asset mix and/or expanding into new markets, we may invest significant time and resources. Initial timetables may not be achieved and price and profitability targets may not prove feasible. External factors, such as compliance with regulations, competitive alternatives in these markets and shifting market preferences, may also impact the successful implementation. Failure to successfully manage these risks could have an adverse effect on our business, financial condition and results of operations.

Table of Contents

Our Financial Results Can Be Impacted By The Cyclicality and Seasonality Of Our Agricultural Business And The Risks Related Thereto - The Company has provided financing to agricultural customers in the Central Valley throughout its history. We recognize the cyclical nature of the industry, often caused by fluctuating commodity prices and changing climatic conditions, and manage these risks accordingly. The Company remains committed to providing credit to agricultural customers and will always have a material exposure to this industry. Although the Company's loan portfolio is believed to be well diversified, at various times during 2014 approximately 41% of the Company's loan balances were outstanding to agricultural borrowers. Commitments are well diversified across various commodities, including dairy, grapes, walnuts, almonds, cherries, apples, pears, and various row crops. Additionally, many individual borrowers are themselves diversified across commodity types, reducing their exposure, and therefore the Company's, to cyclical downturns in any one commodity. The state of California experienced drought conditions during much of 2013 and 2014. Importantly, most of the Company's agricultural customers have access to their own ground water supplies and, therefore, are not as dependent on the delivery of surface water as growers in other parts of California. Although Management continues to believe that current conditions will not have a material impact on credit quality during 2015, the lack of rain will have a continuing adverse impact on our agricultural customers' operating costs, crop yields and crop quality. The longer the drought continues, the more significant this impact will become, particularly if ground water levels reach critical stage.

The Company's service areas can also be significantly impacted by the seasonal operations of the agricultural industry. As a result, the Company's financial results can be influenced by the banking needs of its agricultural customers (e.g., generally speaking during the spring and summer customers draw down their deposit balances and increase loan borrowing to fund the purchase of equipment and the planting of crops. Correspondingly, deposit balances are replenished and loans repaid in late fall and winter as crops are harvested and sold).

We Face Strong Competition From Financial Service Companies And Other Companies That Offer Banking Services That Could Adversely Impact Our Business - The financial services business in our market areas is highly competitive. It is becoming increasingly competitive due to changes in regulation, technological advances, and the accelerating pace of consolidation among financial services providers. We face competition both in attracting deposits and in making loans & leases. We compete for loans & leases principally through the interest rates and loan & lease fees we charge and the efficiency and quality of services we provide. Increasing levels of competition in the banking and financial services business may reduce our market share, decrease loan & lease demand, cause the prices we charge for our services to fall, or decrease our net interest margin by forcing us to offer lower lending interest rates and pay higher deposit interest rates. Therefore, our results may differ in future periods depending upon the nature or level of competition.

Technology and other changes are allowing parties to complete financial transactions that historically have involved banks through alternative methods. For example, consumers can now maintain funds that would have historically been held as bank deposits in brokerage accounts or mutual funds. Consumers can also complete transactions such as paying bills and/or transferring funds directly without the assistance of banks. The process of eliminating banks as intermediaries, known as "disintermediation," could result in the loss of fee income, as well as the loss of customer deposits and the related income generated from those deposits. The loss of these revenue streams and the lower cost deposits as a source of funds could have a material adverse effect on our financial condition and results of operations.

Many of our competitors offer products and services that we do not offer, and many have substantially greater resources, such as greater capital resources and more access to longer term, lower cost funding sources. Many also have greater name recognition and market presence that benefit them in attracting business. In addition, larger competitors may be able to price loans & lease and deposits more aggressively than we do. Our larger competitors generally have easier access to capital, and often on better terms. Some of the financial services organizations with which we compete are not subject to the same degree of regulation as is imposed on bank holding companies and federally insured state-chartered banks, national banks and federal savings institutions. As a result, these non-bank competitors have certain advantages over us in accessing funding and in providing various services. Other competitors are subject to similar regulation but have the advantages of larger established customer bases, higher lending limits, extensive branch networks, numerous automated teller machines, greater advertising and marketing budgets or other factors. Some of our competitors have other advantages, such as tax exemption in the case of credit unions, and lesser regulation in the case of mortgage companies and specialty finance companies.

Deposit Insurance Assessments Could Increase At Any Time, Which Will Adversely Affect Profits - FDIC deposit insurance expense for the years 2014, 2013, and 2012 was $1.0 million, $981,000, and $968,000, respectively. During 2011, the FDIC changed its methodology for calculating deposit premiums, See “Item 1. Business – Supervision and Regulation – Deposit Insurance.” Any increases could have adverse effects on the operating expenses and results of operations of the Company.

Table of Contents

We May Not Be Able To Attract And Retain Skilled People - Our success depends, in large part, on our ability to attract and retain key people. Competition for the best people in most of our activities can be intense and we may not be able to hire people or to retain them. The unexpected loss of services of one or more of our key personnel could have a material adverse impact on our business because of their skills, knowledge of our market, years of industry experience and the difficulty of promptly finding qualified replacement personnel.

Our Internal Operations Are Subject To A Number Of Risks - We are subject to certain operations risks, including, but not limited to, information system failures and errors, customer or employee fraud and catastrophic failures resulting from terrorist acts or natural disasters. We maintain a system of internal controls to mitigate against such occurrences and maintain insurance coverage for such risks that are insurable, but should such an event occur that is not prevented or detected by our internal controls, uninsured or in excess of applicable insurance limits, it could have a significant adverse impact on our business, financial condition or results of operations.

We rely heavily on communications and information systems to conduct our business. Any failure, interruption or breach in security of these systems could result in failures or disruptions in our customer relationship management, general ledger, deposit, loan & leases and other systems. While we have policies and procedures designed to prevent or limit the effect of the failure, interruption or security breach of our information systems, there can be no assurance that any such failures, interruptions or security breaches will not occur or, if they do occur, that they will be adequately addressed. The occurrence of any failures, interruptions or security breaches of our information systems could damage our reputation, result in a loss of customer business, subject us to additional regulatory scrutiny, or expose us to civil litigation and possible financial liability, any of which could have a material adverse effect on our financial condition and results of operations.

The financial services industry is continually undergoing rapid technological change with frequent introductions of new technology-driven products and services. The effective use of technology increases efficiency and enables financial institutions to better serve customers and to reduce costs. Our future success depends, in part, upon our ability to address the needs of our customers by using technology to provide products and services that will satisfy customer demands, as well as to create additional efficiencies in our operations. Many 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 customers. Failure to successfully keep pace with technological change affecting the financial services industry could have a material adverse impact on our business and, in turn, our financial condition and results of operations.

Natural disasters, acts of war or terrorism and other adverse external events could have a significant impact on our ability to conduct business. Such events could affect the stability of our deposit base, impair the ability of borrowers to repay outstanding loans and lessees to make lease payments, impair the value of collateral securing loans & leases, cause significant property damage, result in loss of revenue and/or cause us to incur additional expenses. Operations in several of our markets could be disrupted by both the evacuation of large portions of the population as well as damage and or lack of access to our banking and operation facilities. While we have not experienced such an occurrence to date, other natural disasters, acts of war or terrorism or other adverse external events may occur in the future. Although management has established disaster recovery policies and procedures, the occurrence of any such event could have a material adverse effect on our business, which, in turn, could have a material adverse effect on our financial condition and results of operations.

We Depend On Cash Dividends From The Bank To Meet Our Cash Obligations - As a holding company, dividends from the Bank provide a substantial portion of our cash flow used to service the interest payments on our subordinated debentures issued in 2003 and our other obligations, including cash dividends. See “Item 5. Market for the Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.” Various statutory provisions restrict the amount of dividends our subsidiary bank can pay to us without regulatory approval.

18

Table of Contents

A Lack Of Liquidity Could Adversely Affect Our Operations And Jeopardize Our Business, Financial Condition And Results Of Operations - Liquidity is essential to our business. We rely on our ability to generate deposits and effectively manage the repayment and maturity schedules of our loans and investment securities, respectively, to ensure that we have adequate liquidity to fund our operations. An inability to raise funds through deposits, borrowings, the sale of our investment securities, Federal Home Loan Bank advances, the sale of loans and other sources could have a substantial negative effect on our liquidity. Our most important source of funds consists of deposits. Deposit balances can decrease when customers perceive alternative investments as providing a better risk/return tradeoff. If customers move money out of bank deposits and into other investments, we would lose a relatively low-cost source of funds, increasing our funding costs and reducing our net interest income and net income.

Other primary sources of funds consist of cash flows from operations, investment maturities and sales of investment securities and proceeds from the issuance and sale of any equity and debt securities to investors. Additional liquidity is provided by the ability to borrow from the Federal Reserve Bank and the Federal Home Loan Bank and our ability to raise brokered deposits. We also may borrow funds from third-party lenders, such as other financial institutions. Our access to funding sources in amounts adequate to finance or capitalize our activities, or on terms that are acceptable to us, could be impaired by factors that affect us directly or the bank or non-bank financial services industries or economy in general, such as disruptions in the financial markets or negative views and expectations about the prospects for the bank or non-bank financial services industries.

As of December 31, 2014, approximately $985.7 million, or 47.8%, of our deposits consisted of interest-bearing demand deposits, savings and money market accounts. Based on past experience, we believe that our deposit accounts are relatively stable sources of funds. If we increase interest rates paid to retain deposits, our earnings may be adversely affected, which could have an adverse effect on our business, financial condition and results of operations. Any decline in available funding could adversely impact our ability to originate loans, invest in securities, meet our expenses, pay dividends to our shareholders or to fulfill obligations such as repaying our borrowings or meeting deposit withdrawal demands, any of which could have a material adverse impact on our liquidity, business, financial condition and results of operations.

Cyber Security Is A Growing Risk For Financial Institutions - Our business requires the secure handling of sensitive client information. We also rely heavily on communications and information systems to conduct our business. Cyber incidents include intentional attacks and unintentional events that may present unauthorized access to digital systems that disrupt operations, corrupt data, release sensitive information or cause denial-of-service on our websites. We store, process and transmit account information in connection with lending and deposit relationships, including funds transfer and online banking. A breach of cyber-security systems of the Bank, our vendors or customers, or widely publicized breaches of other financial institutions could significantly harm our reputation, result in a loss of customer business, subject us to additional regulatory scrutiny, or expose us to civil litigation and financial liability. While we have systems and procedures designed to prevent security breaches, we cannot be certain that advances in criminal capabilities, physical system or network break-ins or inappropriate access will not compromise or breach the technology protecting our networks or proprietary client information.

We Rely On Third-Party Vendors For Important Aspects Of Our Operation - We depend on the accuracy and completeness of information and systems provided by certain key vendors, including but not limited to data processing, payroll processing, technology support, investment safekeeping and accounting. Our ability to operate, as well as our financial condition and results of operations, could be negatively affected in the event of an interruption of an information system, an undetected error, a cyber breach, or in the event of a natural disaster whereby certain vendors are unable to maintain business continuity.

We May Be Adversely Affected By The Soundness Of Other Financial Institutions - Financial services institutions are interrelated as a result of trading, clearing, counterparty and other relationships. We have exposure to many different industries and counterparties, and routinely execute transactions with counterparties in the financial services industry, including commercial banks, broker-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. In addition, our credit risk may be exacerbated if our collateral cannot be foreclosed upon or is liquidated at prices not sufficient to recover the full amount of the credit or cover the derivative exposure due. Any such losses could have a material adverse effect on our business, financial condition and results of operations.

Table of Contents

Deterioration Of Credit Quality Or Insolvency Of Insurance Companies May Impede Our Ability To Recover Losses - The financial crisis led certain major insurance companies to be downgraded by rating agencies. We have property, casualty and financial institution risk coverage underwritten by several insurance companies. In addition, some of our investments in obligations of state and political subdivisions are insured by insurance companies. While we closely monitor credit ratings of our insurers and insurers of our municipality securities, and we are poised to make quick changes if needed, we cannot predict an unexpected inability to honor commitments. We also invest in bank-owned life insurance policies on certain members of senior Management, which may lose value in the event of the carriers' insolvency. In the event that our bank-owned life insurance policy carriers' credit ratings fall below investment grade, we may exchange policies underwritten by them to another carrier at a cost charged by the original carrier, or we may terminate the policies which may result in adverse tax consequences.

Our loan portfolio is also primarily secured by properties located in earthquake or fire-prone zones. In the event of a disaster that causes pervasive damage to the region in which we operate, not only the Bank, but also the loan collateral may suffer losses not recovered by insurance.

Risks Associated With Our Industry

We Are Subject To Government Regulation That Could Limit Or Restrict Our Activities, Which In Turn Could Adversely Impact Our Financial Performance - The financial services industry is regulated extensively and we are subject to examination, supervision and comprehensive regulations by various regulatory agencies. Federal and state regulations are designed primarily to protect the deposit insurance funds and consumers, and not to benefit our stockholders. These regulations can sometimes impose significant limitations on our operations and increase our cost of doing business.

Further, federal monetary policy, particularly as implemented by the FRB, significantly affects economic conditions for us.

Proposals to change the laws and regulations governing the operations and taxation of, and federal insurance premiums paid by, banks and other financial institutions and companies that control such institutions are frequently raised in the U.S. Congress, the California legislature and before bank regulatory authorities. The likelihood of any major changes in the future and the impact such changes, including the Dodd-Frank Act, might have on us or the Bank are impossible to determine. Similarly, proposals to change the accounting treatment applicable to banks and other depository institutions are frequently raised by the SEC, the federal banking agencies, the IRS and other appropriate authorities. The likelihood and impact of any additional future changes in law or regulation and the impact such changes might have on us or the Bank are impossible to determine at this time.

Risks Associated With Our Stock

Our Stock Trades Less Frequently Than Others - The Company’s common stock is not widely held or listed on any exchange. However, trades are reported on the OTCQX under the symbol "FMCB." Management is aware that there are private transactions in the Company’s common stock. However, the limited trading market for the Company’s common stock may make it difficult for stockholders to dispose of their shares.

Our Stock Price Is Affected By A Variety Of Factors - Stock price volatility may make it more difficult for you to resell your common stock when you want and at prices you find attractive. Our stock price can fluctuate significantly in response to a variety of factors discussed in this section, including, among other things:

· actual or anticipated variations in quarterly results of operations;

· operating and stock price performance of other companies that investors deem comparable to our Company;

- news reports relating to trends, concerns and other issues in the financial services industry;
- available investment liquidity in our market area since our stock is not listed on any exchange; and
- perceptions in the marketplace regarding our Company and/or its competitors.

Table of Contents

Our Common Stock Is Not An Insured Deposit - Our common stock is not a bank deposit and, therefore, is not insured against loss by the FDIC, any other deposit insurance fund or by any other public or private entity. Investment in our common stock is inherently risky for the reasons described in this “Risk Factors” section and elsewhere in this report and is subject to the same market forces that affect the price of common stock in any company. As a result, if you acquire our common stock, you may lose some or all of your investment.

Item 1B. Unresolved Staff Comments

The Company has no unresolved comments received from staff at the SEC.

Item 2. Properties

Farmers & Merchants Bancorp along with its subsidiaries are headquartered in Lodi, California. Executive offices are located at 111 W. Pine Street. Banking services are provided in twenty-four branch locations in the Company's service area. Of the twenty-four branches, fifteen are owned and nine are leased. The expiration of these leases occurs between the years 2015 and 2024. See Note 19, located in “Item 8. Financial Statements and Supplementary Data.”

Item 3. Legal Proceedings

Certain lawsuits and claims arising in the ordinary course of business have been filed or are pending against the Company or its subsidiaries. Based upon information available to the Company, its review of such lawsuits and claims and consultation with its counsel, the Company believes the liability relating to these actions, if any, would not have a material adverse effect on its consolidated financial statements.

There are no material proceedings adverse to the Company to which any director, officer or affiliate of the Company is a party.

Item 4. Mine Safety Disclosures

Not Applicable

PART II

Item 5. Market for Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

The common stock of Farmers & Merchants Bancorp is not widely held or listed on any exchange. However, trades are reported on the OTCQX (prior to January 12, 2015, the Over the Counter (“OTC”) Bulletin Board) under the symbol “FMCB.” Additionally, management is aware that there are private transactions in the Company’s common stock.

Table of Contents

The following table summarizes the actual high, low, and close sale prices for the Company's common stock since the first quarter of 2013. These figures are based on activity posted on the OTC Bulletin Board and on private transactions between individual stockholders that are reported to the Company.

	Calendar Quarter	High	Low	Close	Cash Dividends Declared (Per Share)
2014	Fourth quarter	$466	$450	$463	$ 6.40
	Third quarter	445	430	450	-
	Second quarter	451	420	433	6.30
	First quarter	448	417	425	-

	Calendar Quarter	High	Low	Close	Cash Dividends Declared (Per Share)
2013	Fourth quarter	$417	$405	$417	$ 6.30
	Third quarter	420	400	415	-
	Second quarter	500	384	400	6.20
	First quarter	470	375	470	-

As of January 31, 2015, there were approximately 1,449 stockholders of record of the Company’s common stock.

The Company and, before the Company was formed, the Bank, has paid cash dividends for the past 80 consecutive years. There are limitations under Delaware corporate law as to the amounts of cash dividends that may be paid by the Company. Additionally, if we decided to defer interest on our 2003 subordinated debentures, we would be prohibited from paying cash dividends on the Company’s common stock. The Company is dependent on cash dividends paid by the Bank to fund its cash dividend payments to its stockholders. There are regulatory limitations on cash dividends that may be paid by the Bank under state and federal laws. See “Item 1. Business – Supervision and Regulation.”

In 1998, the Board approved the Company’s first common stock repurchase program. This program has been extended and expanded several times since then, and most recently, on September 11, 2012, the Board of Directors approved increasing the funds available for the Company’s common stock repurchase program to $20 million over the three-year period ending September 30, 2015.

Repurchases under the program may be made from time to time on the open market or through private transactions. The repurchase program also requires that no purchases may be made if the Bank would not remain “well-capitalized” after the repurchase.

There were no shares repurchased by the Company during 2014. The approximate dollar value of shares that may yet be purchased under the program is $20 million.

On August 5, 2008, the Board of Directors approved a Share Purchase Rights Plan (the “Rights Plan”), pursuant to which the Company entered into a Rights Agreement dated August 5, 2008, with Computershare (formerly Registrar and Transfer Company), as Rights Agent, and the Company declared a dividend of a right to acquire one preferred share purchase right (a “Right”) for each outstanding share of the Company’s common stock, $0.01 par value per share, to stockholders of record at the close of business on August 15, 2008. Generally, the Rights are only triggered and become exercisable if a person or group (the “Acquiring Person”) acquires beneficial ownership of 10 percent or more of the Company’s common stock or announces a tender offer for 10 percent or more of the Company’s common stock.

The Rights Plan is similar to plans adopted by many other publicly traded companies. The effect of the Rights Plan is to discourage any potential acquirer from triggering the Rights without first convincing Farmers & Merchants Bancorp’s Board of Directors that the proposed acquisition is fair to, and in the best interest of, all of the stockholders of the Company. The provisions of the Plan will substantially dilute the equity and voting interest of any potential acquirer unless the Board of Directors approves of the proposed acquisition. Each Right, if and when exercisable, will entitle the registered holder to purchase from the Company one one-hundredth of a share of Series A Junior Participating Preferred Stock, no par value, at a purchase price of $1,200 for each one one-hundredth of a share, subject to adjustment. Each holder of a Right (except for the Acquiring Person, whose Rights will be null and void upon such event) shall thereafter have the right to receive, upon exercise, that number of Common Shares of the Company having a market value of two times the exercise price of the Right. At any time before a person becomes an Acquiring Person, the Rights can be redeemed, in whole, but not in part, by Farmers and Merchants Bancorp’s Board of Directors at a price of $0.001 per Right. The Rights Plan will expire on August 5, 2018.

Table of Contents

On December 4, 2014, the Company issued 6,200 shares of common stock to the Bank's non-qualified defined contribution retirement plans. See Note 16, located in "Item 8. Financial Statements and Supplementary Data." These shares were issued at a price of $450 per share based upon a valuation completed by a nationally recognized bank consulting and advisory firm and in reliance upon the exemption in Section 4(2) of the Securities Act of 1933, as amended, the regulations promulgated thereunder. Most of the proceeds were contributed to the Bank as equity capital.

Performance Graphs

The following graph compares the Company's cumulative total stockholder return on common stock from December 31, 2009 to December 31, 2014 to that of: (i) the Morningstar Banks Index - Regional (US) Industry Group; and (ii) the cumulative total return of the New York Stock Exchange market index. The graph assumes an initial investment of $100 on December 31, 2009 and reinvestment of dividends. The stock price performance set forth in the following graph is not necessarily indicative of future price performance. The Company's stock price data is based on activity posted on the OTC Bulletin Board and on private transactions between individual stockholders that are reported to the Company. This data was furnished by Zacks SEC Compliance Services Group.

This graph shall not be deemed filed or incorporated by reference into any filing under the Securities Act of 1933.

Table of Contents

Item 6. Selected Financial Data

Farmers & Merchants Bancorp
Five Year Financial Summary of Operations
(in thousands except per share data)

Summary of Income:	2014	2013	2012	2011	2010
Total Interest Income	$81,521	$76,531	$78,491	$82,354	$84,461
Total Interest Expense	2,813	2,891	5,140	7,974	9,685
Net Interest Income	78,708	73,640	73,351	74,380	74,776
Provision for Credit Losses	1,175	425	1,850	6,775	14,735
Net Interest Income After Provision for Credit Losses	77,533	73,215	71,501	67,605	60,041
Total Non-Interest Income	14,329	15,937	14,110	12,274	17,185
Total Non-Interest Expense	51,366	50,870	48,277	45,028	43,939
Income Before Income Taxes	40,496	38,282	37,334	34,851	33,287
Provision for Income Taxes	15,094	14,221	13,985	12,642	12,169
Net Income	$25,402	$24,061	$23,349	$22,209	$21,118
Balance Sheet Data:					
Total Assets	$2,360,551	$2,076,073	$1,974,686	$1,919,684	$1,841,491
Loans & Leases	1,712,244	1,388,236	1,246,902	1,163,078	1,176,002
Allowance for Credit Losses	35,401	34,274	34,217	33,017	32,261
Investment Securities	430,405	473,144	486,383	542,912	493,581
Deposits	2,064,073	1,807,691	1,722,026	1,626,197	1,566,503
Federal Home Loan Bank Advances	-	-	-	530	591
Shareholders' Equity	233,178	209,904	205,033	189,346	173,241
Selected Ratios:					
Return on Average Assets	1.17 %	1.21 %	1.22 %	1.19 %	1.19 %
Return on Average Equity	11.43 %	11.54 %	11.62 %	12.10 %	12.25 %
Dividend Payout Ratio	39.05 %	40.41 %	40.34 %	41.24 %	41.93 %
Average Loans & Leases to Average Deposits	79.99 %	74.28 %	72.02 %	74.48 %	79.03 %
Average Equity to Average Assets	10.28 %	10.52 %	10.45 %	9.85 %	9.74 %
Period-end Shareholders' Equity to Total Assets	9.88 %	10.11 %	10.38 %	9.86 %	9.41 %
Basic Per Share Data:					
Net Income [1]	$32.64	$30.93	$29.99	$28.49	$27.05
Cash Dividends Per Share	$12.70	$12.50	$12.10	$11.75	$11.35

(1) Based on the weighted average number of shares outstanding of 778,358, 777,882, 778,648, 779,424, and 780,619 for the years ended December 31, 2014, 2013, 2012, 2011, and 2010, respectively.

Table of Contents

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

Overview

Although the Company has initiated efforts to expand its geographic footprint into Walnut Creek and Irvine, CA (see Item 1: Business – Service Area), the Company's primary service area remains the mid Central Valley of California, a region that can be significantly impacted by the seasonal needs of the agricultural industry. Accordingly, discussion of the Company's Financial Condition and Results of Operations is influenced by the seasonal banking needs of its agricultural customers (e.g., during the spring and summer customers draw down their deposit balances and increase loan borrowing to fund the purchase of equipment and planting of crops. Correspondingly, deposit balances are replenished and loans repaid in late fall and winter as crops are harvested and sold).

The Five-Year Period: 2010 through 2014

Through much of 2007 the economy in our primary service area was strong, the stock market rising and individuals and businesses doing well. Then in October 2007 the financial markets started what would become a major adjustment and an economic recession began, the impact of which is still being felt today in the Central Valley of California. The Central Valley was one of the hardest hit areas in the country during the recession. In many areas housing prices declined as much as 60% and unemployment reached 15% or more. Although the economy has stabilized throughout most of the Central Valley, housing prices for the most part have not recovered significantly and unemployment levels remain well above those in other areas of the state and country.

Despite this difficult economic environment, in management's opinion, the Company's operating performance over the past five years has been exceptionally strong.

(in thousands, except per share data)

Financial Performance Indicator	2014	2013	2012	2011	2010
Net Income	$25,402	$24,062	$23,349	$22,209	$21,118
Total Assets	2,360,551	2,076,073	1,974,686	1,919,684	1,841,491
Total Loans	1,712,244	1,388,236	1,246,902	1,163,078	1,176,002
Total Deposits	2,064,073	1,807,691	1,722,026	1,626,197	1,566,503
Total Shareholders' Equity	233,178	209,904	205,033	189,346	173,241
Total Risk-Based Capital Ratio	12.93 %	13.99 %	14.96 %	14.86 %	13.82 %
Non-Performing Loans as a % of Total Loans	0.13 %	0.19 %	0.74 %	0.36 %	0.45 %
Substandard Loans as a % of Total Loans	0.21 %	0.41 %	1.72 %	3.67 %	3.40 %
Net Charge-Offs to Average Loans	0.00 %	0.03 %	0.05 %	0.51 %	1.04 %
Loan Loss Allowance as a % of Total Loans	2.06 %	2.46 %	2.74 %	2.83 %	2.74 %
Return on Average Assets	1.17 %	1.21 %	1.22 %	1.19 %	1.19 %
Return on Average Equity	11.43 %	11.54 %	11.62 %	12.10 %	12.25 %
Earnings Per Share	32.64	30.93	29.99	28.49	27.05
Cash Dividends Per Share	12.70	12.50	12.10	11.75	11.35
Cash Dividends Declared	9,919	9,723	9,418	9,158	8,855
# Shares Repurchased During Year	-	-	1,542	-	1,520
Average Share Price of Repurchased Shares	-	-	373	-	400
High Stock Price – Fourth Quarter	466	417	405	400	425
Low Stock Price – Fourth Quarter	450	405	355	345	400
Closing Stock Price – Fourth Quarter	463	417	405	400	415

25

Although the Company was not entirely immune to the pressures that a struggling economy brought to bear, management believes that the Company's performance compared very favorably to its peer banks during the five-year period ending December 31, 2014:

- Net income totaled $116.1 million and never dropped below $21.0 million in any single year.
- Return on Average Assets never dropped below 1.17% in any single year.
- Total assets increased 32.5% to $2.4 billion.
- Total loans & leases increased 41.2% to $1.7 billion.
- Total deposits increased 37.8% to $2.1 billion.

More recently:

- In 2014, the Company earned $25.4 million for a return on average assets of 1.17%, and our return on average assets averaged 1.20% over the five-year period. Importantly, these strong results were generated at the same time the Company increased its credit loss allowance by $1.2 million, to $35.4 million or 2.06% of total loans & leases.
- In 2014, the Company increased its cash dividend per share by 2.0% over 2013 levels, and our strong financial performance has allowed us to increase dividends every year during this five-year period.
- The Company's total risk based capital ratio was –12.93% at December 31, 2014, and the Bank achieved the highest regulatory classification of "well capitalized" in each of the five years. See "Financial Condition – Capital."
- The Company began to diversify its: (1) geographic market by establishing new branches in Walnut Creek and Irvine, CA; and (2) lending products by introducing equipment leasing.
- Despite continuing sluggish economic conditions in the Company's local markets, the Company's asset quality remains very strong compared to peer banks at the present time, when measured by: (1) net charge-offs of 0.33% of average loans & leases during this five-year period; and (2) substandard loans & leases totaling 0.21% of total loans & leases at December 31, 2014. See "Results of Operations – Provision and Allowance for Credit Losses" and "Financial Condition – Classified Loans & Leases and Non-Performing Assets."

As a result of this strong earnings performance, capital position, and asset quality, stockholders have benefited from the fact that cash dividends per share have increased 15.4% since 2009, and totaled $60.40 per share over the five-year period. The 2014 dividend of $12.70 per share represents a 2.7% yield based upon the December 31, 2014 ending stock price of $463 per share.

Looking Forward: 2015 and Beyond

In management's opinion, the following key issues will continue to influence the financial results of the Company in 2015 and future years:

- The Company's earnings are heavily dependent on its net interest margin, which is sensitive to such factors as: (1) market interest rates; (2) the mix of our earning assets and interest-bearing liabilities; and (3) competitor pricing strategies.
  - During the third quarter of 2007, the FRB began dropping short-term market rates. Market rates remain low, and management does not expect this to change significantly during 2015.

Deposit growth outstripped loan growth in 2010 – 2012 and, as a result, the Company's loan-to-deposit ratio dropped. This resulted in a higher percentage of our earning assets being placed into lower yielding investment securities, interest-bearing deposits with banks, and Federal Funds Sold. Although loan growth picked-up substantially in 2013 - 2014, partially as a result of our expansion into Walnut Creek and equipment leasing, we still face a difficult economic environment in the Central Valley combined with a very competitive pricing environment. No assurances can be given that this recent growth in the loan & lease portfolio will continue.

Table of Contents

- Aggressive competitor pricing for loans, leases and deposits has often required the Company to respond in order to retain key customers.

The combination of low market interest rates and aggressive competitor pricing has caused the Company's net interest margin to decline from 4.89% in the second quarter of 2007 to 4.14% in the fourth quarter of 2014. The Company expects many of these factors to continue to push the net interest margin lower in 2015. See "Item 7A. Quantitative and Qualitative Disclosures About Market Risk - Interest Rate Risk."

- The Company's results are impacted by changes in the credit quality of its borrowers. Substandard loans & leases totaled $3.6 million or 0.21% of total loans & leases at December 31, 2014 vs. $5.8 million or 0.41% of total loans at December 31, 2013, and a peak of $62.8 million or 5.17% of total loans at December 31, 2009. Management believes, based on information currently available, that these levels are adequately covered by the Company's $35.4 million allowance for credit losses as of December 31, 2014. See "Results of Operations - Provision and Allowance for Credit Losses" and "Financial Condition – Classified Loans & Leases and Non-Performing Assets." The Company's provision for credit losses was $1.2 million in 2014, compared to $425,000 in 2013 and $1.9 million in 2012. See "Item 1A. Risk Factors."

- FDIC deposit insurance expense for the years 2014, 2013, and 2012 was $1.0 million, $981,000, and $968,000, respectively. In 2011 the FDIC changed its methodology for calculating deposit premiums. See "Item 1. Business – Supervision and Regulation – Deposit Insurance." While FDIC deposit insurance assessments have stabilized in recent years, they remain well above the pre-recession level the Company paid in 2007.

- Congress and the Obama Administration are continuing to implement broad changes to the regulation of consumer financial products and the financial services industry as a whole. These changes could significantly affect the Company's product offerings, pricing and profitability in areas such as debit and credit cards, home mortgages and deposit service charges.

- The Company has expanded its geographic footprint to include Walnut Creek, CA and Irvine, CA and has established equipment leasing as a new line of business. Additional expansion is underway in Concord, CA, an area contiguous to Walnut Creek (see Item 1: Business – Service Area). Although Management believes that these initiatives will result in increased asset growth and earnings, along with reduced concentration risks, the start-up costs related to staff and facilities are significant and will take time to cover.

Results of Operations

The following discussion and analysis is intended to provide a better understanding of Farmers & Merchants Bancorp and its subsidiaries' performance during each of the years in the three-year period ended December 31, 2014, and the material changes in financial condition, operating income, and expense of the Company and its subsidiaries as shown in the accompanying financial statements.

Net Interest Income/Net Interest Margin

The tables on the following pages reflect the Company's average balance sheets and volume and rate analysis for the years ending 2014, 2013, and 2012. Average balance amounts for assets and liabilities are the computed average of daily balances.

Net interest income is the amount by which the interest and fees on loans & leases and other interest-earning assets exceed the interest paid on interest-bearing sources of funds. For the purpose of analysis, the interest earned on tax-exempt investments and municipal loans is adjusted to an amount comparable to interest subject to normal income taxes. This adjustment is referred to as "tax equivalent" adjustment and is noted wherever applicable. The presentation of net interest income and net interest margin on a tax equivalent basis is a common practice within the banking industry.

Table of Contents

The Volume and Rate Analysis of Net Interest Income summarizes the changes in interest income and interest expense based on changes in average asset and liability balances (volume) and changes in average rates (rate). For each category of interest-earning assets and interest-bearing liabilities, information is provided with respect to changes attributable to: (1) changes in volume (change in volume multiplied by initial rate); (2) changes in rate (change in rate multiplied by initial volume); and (3) changes in rate/volume (allocated in proportion to the respective volume and rate components).

The Company's earning assets and rate sensitive liabilities are subject to repricing at different times, which exposes the Company to income fluctuations when interest rates change. In order to minimize income fluctuations, the Company attempts to match asset and liability maturities. However, some maturity mismatch is inherent in the asset and liability mix. See "Item 7A. Quantitative and Qualitative Disclosures About Market Risk - Interest Rate Risk."

Table of Contents

Farmers & Merchants Bancorp
Year-to-Date Average Balances and Interest Rates
(Interest and Rates on a Taxable Equivalent Basis)
(in thousands)

	Year Ended December 31, 2014		
Assets	Balance	Interest	Rate
Interest Bearing Deposits with Banks	$62,452	$158	0.25%
Investment Securities:			
Government Agency & Government-Sponsored Entities	18,383	186	1.01%
Obligations of States and Political Subdivisions - Non-Taxable	65,202	3,552	5.45%
Mortgage Backed Securities	314,293	7,174	2.28%
Other	36,643	379	1.03%
Total Investment Securities	434,521	11,291	2.60%
Loans & Leases			
Real Estate	1,027,795	49,914	4.86%
Home Equity Lines and Loans	34,017	1,881	5.53%
Agricultural	224,859	8,997	4.00%
Commercial	179,420	8,655	4.82%
Consumer	5,143	307	5.97%
Other	17	1	5.88%
Leases	28,136	1,555	5.53%
Total Loans & Leases	1,499,387	71,310	4.76%
Total Earning Assets	1,996,360	$82,759	4.15%
Unrealized Gain on Securities Available-for-Sale	1,462		
Allowance for Credit Losses	(34,316)		
Cash and Due From Banks	32,219		
All Other Assets	166,860		
Total Assets	$2,162,585		
Liabilities & Shareholders' Equity			
Interest Bearing Deposits			
Interest Bearing DDA	$311,911	$167	0.05%
Savings and Money Market	627,129	1,051	0.17%
Time Deposits	430,968	1,268	0.29%
Total Interest Bearing Deposits	1,370,008	2,486	0.18%
Federal Home Loan Bank Advances	3,643	5	0.14%
Subordinated Debt	10,310	322	3.12%
Total Interest Bearing Liabilities	1,383,961	$2,813	0.20%
Interest Rate Spread			3.94%
Demand Deposits	504,470		
All Other Liabilities	51,946		
Total Liabilities	1,940,377		
Shareholders' Equity	222,208		
Total Liabilities & Shareholders' Equity	$2,162,585		
Impact of Non-Interest Bearing Deposits and Other Liabilities			0.06%
Net Interest Income and Margin on Total Earning Assets		79,946	4.00%

Tax Equivalent Adjustment	(1,238)	
Net Interest Income	$78,708	3.94%

Notes: Yields on municipal securities have been calculated on a fully taxable equivalent basis. Loan interest income includes fee income and unearned discount in the amount of $5.1 million for the year ended December 31, 2014. Non-accrual loans and lease financing receivables have been included in the average balances. Yields on securities available-for-sale are based on historical cost.

Table of Contents

Farmers & Merchants Bancorp
Year-to-Date Average Balances and Interest Rates
(Interest and Rates on a Taxable Equivalent Basis)
(in thousands)

	Year Ended December 31, 2013		
Assets	Balance	Interest	Rate
Interest Bearing Deposits with Banks	$30,743	$79	0.26%
Investment Securities:			
Government Agency & Government-Sponsored Entities	28,033	256	0.91%
Obligations of States and Political Subdivisions - Non-Taxable	68,832	3,929	5.71%
Mortgage Backed Securities	374,927	8,117	2.16%
Other	52,318	598	1.14%
Total Investment Securities	524,110	12,900	2.46%
Loans & Leases			
Real Estate	868,855	46,056	5.30%
Home Equity Lines and Loans	38,293	2,187	5.71%
Agricultural	204,103	8,715	4.27%
Commercial	150,456	7,546	5.02%
Consumer	4,888	313	6.40%
Other	230	13	5.65%
Leases	2,507	91	3.63%
Total Loans & Leases	1,269,332	64,921	5.11%
Total Earning Assets	1,824,185	$77,900	4.27%
Unrealized Gain on Securities Available-for-Sale	3,453		
Allowance for Credit Losses	(34,227)		
Cash and Due From Banks	33,648		
All Other Assets	155,715		
Total Assets	$1,982,774		
Liabilities & Shareholders' Equity			
Interest Bearing Deposits			
Interest Bearing DDA	$259,348	$119	0.05%
Savings and Money Market	577,214	947	0.16%
Time Deposits	444,605	1,482	0.33%
Total Interest Bearing Deposits	1,281,167	2,548	0.20%
Other Borrowed Funds	12,265	16	0.13%
Subordinated Debt	10,310	327	3.17%
Total Interest Bearing Liabilities	1,303,742	$2,891	0.22%
Interest Rate Spread			4.05%
Demand Deposits	427,673		
All Other Liabilities	42,783		
Total Liabilities	1,774,198		
Shareholders' Equity	208,576		
Total Liabilities & Shareholders' Equity	$1,982,774		
Impact of Non-Interest Bearing Deposits and Other Liabilities			0.06%
Net Interest Income and Margin on Total Earning Assets		75,009	4.11%

Tax Equivalent Adjustment	(1,369)	
Net Interest Income	$73,640	4.04 %

Notes: Yields on municipal securities have been calculated on a fully taxable equivalent basis. Loan interest income includes fee income and unearned discount in the amount of $4.1 million for the year ended December 31, 2013. Non-accrual loans and lease financing receivables have been included in the average balances. Yields on securities available-for-sale are based on historical cost.

Table of Contents

Farmers & Merchants Bancorp
Year-to-Date Average Balances and Interest Rates
(Interest and Rates on a Taxable Equivalent Basis)
(in thousands)

	Year Ended December 31, 2012		
Assets	Balance	Interest	Rate
Interest Bearing Deposits with Banks	$43,351	$110	0.25%
Investment Securities:			
Government Agency & Government-Sponsored Entities	56,396	577	1.02%
Obligations of States and Political Subdivisions - Non-Taxable	70,432	4,047	5.75%
Mortgage Backed Securities	399,121	9,182	2.30%
Other	15,358	182	1.19%
Total Investment Securities	541,307	13,988	2.58%
Loans			
Real Estate	767,555	44,329	5.78%
Home Equity Lines and Loans	46,405	2,656	5.72%
Agricultural	200,040	9,888	4.94%
Commercial	163,089	8,455	5.18%
Consumer	5,820	456	7.84%
Other	237	13	5.49%
Total Loans	1,183,146	65,797	5.56%
Total Earning Assets	1,767,804	$79,895	4.52%
Unrealized Gain on Securities Available-for-Sale	12,116		
Allowance for Loan Losses	(33,248)		
Cash and Due From Banks	33,941		
All Other Assets	140,998		
Total Assets	$1,921,611		
Liabilities & Shareholders' Equity			
Interest Bearing Deposits			
Interest Bearing DDA	$231,813	$167	0.07%
Savings and Money Market	540,063	1,281	0.24%
Time Deposits	496,327	2,291	0.46%
Total Interest Bearing Deposits	1,268,203	3,739	0.29%
Securities Sold Under Agreement to Repurchase	28,197	1,018	3.61%
Other Borrowed Funds	3,698	36	0.97%
Subordinated Debt	10,310	347	3.37%
Total Interest Bearing Liabilities	1,310,408	$5,140	0.39%
Interest Rate Spread			4.13%
Demand Deposits	374,677		
All Other Liabilities	35,631		
Total Liabilities	1,720,716		
Shareholders' Equity	200,895		
Total Liabilities & Shareholders' Equity	$1,921,611		
Impact of Non-Interest Bearing Deposits and Other Liabilities			0.10%
Net Interest Income and Margin on Total Earning Assets		74,755	4.23%

Tax Equivalent Adjustment	(1,404)	
Net Interest Income	$73,351	4.15%

Notes: Yields on municipal securities have been calculated on a fully taxable equivalent basis. Loan interest income includes fee income and unearned discount in the amount of $3.1 million for the year ended December 31, 2012. Non-accrual loans and lease financing receivables have been included in the average balances. Yields on securities available-for-sale are based on historical cost.

Table of Contents

Farmers & Merchants Bancorp
Volume and Rate Analysis of Net Interest Revenue

(Interest and Rates on a Taxable Equivalent Basis) (in thousands)	2014 versus 2013 Amount of Increase (Decrease) Due to Change in:		
Interest Earning Assets	Volume	Rate	Net Chg.
Interest Bearing Deposits with Banks	$80	$(1)	$79
Investment Securities:			
Government Agency & Government-Sponsored Entities	(96)	26	(70)
Obligations of States and Political Subdivisions - Non-Taxable	(202)	(175)	(377)
Mortgage Backed Securities	(1,366)	423	(943)
Other	(166)	(53)	(219)
Total Investment Securities	(1,830)	221	(1,609)
Loans & Leases:			
Real Estate	7,941	(4,083)	3,858
Home Equity Lines and Loans	(238)	(68)	(306)
Agricultural	851	(569)	282
Commercial	1,406	(297)	1,109
Consumer	16	(22)	(6)
Other	(13)	1	(12)
Leases	1,392	72	1,464
Total Loans & Leases	11,355	(4,966)	6,389
Total Earning Assets	9,605	(4,746)	4,859
Interest Bearing Liabilities			
Interest Bearing Deposits:			
Interest Bearing DDA	26	22	48
Savings and Money Market	84	20	104
Time Deposits	(44)	(170)	(214)
Total Interest Bearing Deposits	66	(128)	(62)
Other Borrowed Funds	(12)	1	(11)
Subordinated Debt	-	(5)	(5)
Total Interest Bearing Liabilities	54	(132)	(78)
Total Change	$9,551	$(4,614)	$4,937

Notes: Rate/volume variance is allocated based on the percentage relationship of changes in volume and changes in rate to the total "net change." The above figures have been rounded to the nearest whole number.

Table of Contents
Farmers & Merchants Bancorp
Volume and Rate Analysis of Net Interest Revenue

(Interest and Rates on a Taxable Equivalent Basis) (in thousands)	2013 versus 2012 Amount of Increase (Decrease) Due to Change in:		
Interest Earning Assets	Volume	Rate	Net Chg.
Interest Bearing Deposits with Banks	$(32)	$1	$(31)
Investment Securities:			
Government Agency & Government-Sponsored Entities	(264)	(57)	(321)
Obligations of States and Political Subdivisions - Non-Taxable	(92)	(27)	(119)
Mortgage Backed Securities	(540)	(525)	(1,065)
Other	422	(6)	416
Total Investment Securities	(474)	(615)	(1,089)
Loans & Leases:			
Real Estate	5,554	(3,827)	1,727
Home Equity Lines and Loans	(463)	(6)	(469)
Agricultural	197	(1,370)	(1,173)
Commercial	(640)	(269)	(909)
Consumer	(67)	(76)	(143)
Leases	91	-	91
Total Loans & Leases	4,672	(5,548)	(876)
Total Earning Assets	4,166	(6,162)	(1,996)
Interest Bearing Liabilities			
Interest Bearing Deposits:			
Interest Bearing DDA	18	(66)	(48)
Savings and Money Market	83	(417)	(334)
Time Deposits	(221)	(588)	(809)
Total Interest Bearing Deposits	(120)	(1,071)	(1,191)
Securities Sold Under Agreement to Repurchase	(1,018)	-	(1,018)
Other Borrowed Funds	30	(50)	(20)
Subordinated Debt	-	(20)	(20)
Total Interest Bearing Liabilities	(1,108)	(1,141)	(2,249)
Total Change	$5,274	$(5,021)	$253

Notes: Rate/volume variance is allocated based on the percentage relationship of changes in volume and changes in rate to the total "net change." The above figures have been rounded to the nearest whole number.

Table of Contents
2014 Compared to 2013
Net interest income increased 6.9% to $78.7 million during 2014. On a fully tax equivalent basis, net interest income increased 6.6% and totaled $79.9 million during 2014 compared to $75.0 million for 2013. As more fully discussed below, the increase in net interest income was primarily due to an increase in average earning assets offset somewhat by a decrease in the net interest margin.

Net interest income on a tax equivalent basis, expressed as a percentage of average total earning assets, is referred to as the net interest margin. For 2014, the Company's net interest margin was 4.00% compared to 4.11% in 2013. This decrease in net interest margin was due primarily to declining yields on earning assets that exceeded a corresponding drop in funding costs, offset somewhat by an increase in the mix of loans & leases as a percentage of total earning assets.

Average loans & leases totaled $1.5 billion for the year ended December 31, 2014; an increase of $230.1 million compared to the year ended December 31, 2013. Loans & leases increased from 69.6% of average earning assets during 2013 to 75.1% in 2014. Because of the impact of decreases in market interest rates from mid-September 2007 through December 2008, and the continuing low rate environment since then, the year-to-date yield on the loan & lease portfolio declined to 4.76% for the year ended December 31, 2014, compared to 5.11% for the year ended December 31, 2013. This lower yield partially offset the impact of an increase in average loan & lease balances but still resulted in interest revenue from loans & leases increasing 9.8% to $71.3 million for 2014. The Company has been experiencing aggressive competitor pricing for loans & leases to which it may need to continue to respond in order to retain key customers. This could place even greater negative pressure on future loan & lease yields and net interest margin.

The investment portfolio is the other main component of the Company's earning assets. Historically, the Company invested primarily in: (1) mortgage-backed securities issued by government-sponsored entities; (2) debt securities issued by government agencies and government-sponsored entities; and (3) investment grade bank-qualified municipal bonds. However, during 2012, when loan demand lagged deposit growth, resulting in significant liquidity, the Company began to selectively add corporate securities (floating rate and fixed rate with maturities less than 5 years) to the portfolio in order to obtain yields that exceed government agency securities of equivalent maturity without subjecting the Company to the interest rate risk associated with mortgage-backed securities. Since the risk factor for these types of investments is generally lower than that of loans & leases, the yield earned on investments is generally less than that of loans & leases.

Average investment securities decreased $89.6 million in 2014 compared to the average balance during 2013. As a result, tax equivalent interest income on securities decreased $1.6 million to $11.3 million for the year ended December 31, 2014, compared to $12.9 million for the year ended December 31, 2013. The average yield, on a tax equivalent basis, in the investment portfolio was 2.60% in 2014 compared to 2.46% in 2013. This overall increase in yield was caused primarily by a decrease in the mix of corporate securities as a percentage of total securities and an increase in the yield on the Company's mortgage-backed securities portfolio due to the sale of certain lower yielding MBS. See "Financial Condition – Investment Securities" for a discussion of the Company's investment strategy in 2014.
Net interest income on the Schedule of Year-to-Date Average Balances and Interest Rates is shown on a tax equivalent basis, which is higher than net interest income as reflected on the Consolidated Statements of Income because of adjustments that relate to income on securities that are exempt from federal income taxes.

Interest-bearing deposits with banks and overnight investments in Federal Funds Sold are additional earning assets available to the Company. Average interest-bearing deposits with banks consisted of FRB deposits. Balances with the FRB earn interest at the Fed Funds rate, which has been 0.25% since December 2008. Average interest-bearing deposits with banks for the year ended December 31, 2014, was $62.5 million, an increase of $31.7 million compared to the average balance for the year ended December 31, 2013. Interest income on interest-bearing deposits with banks for the year ended December 31, 2014, increased $79,000 to $158,000 from the year ended December 31, 2013.

Average interest-bearing liabilities increased $80.2 million or 6.2% during the twelve months ended December 31, 2014. Of that increase: (1) interest-bearing deposits increased $88.8 million; (2) FHLB Advances decreased $8.6 million; and (3) subordinated debt remained unchanged.

Table of Contents

The $88.8 million increase in average interest-bearing deposits was primarily in lower cost interest-bearing DDA, and savings and money market deposits, which increased $102.5 million since 2013, as higher cost time deposits decreased by $13.6 million. See "Financial Condition – Deposits" for a discussion of trends in the Company's deposit base. Total interest expense on deposits was $2.5 million for 2014 and 2013. The average rate paid on interest-bearing deposits was 0.18% in 2014 and 0.20% in 2013. Since most of the Company's interest-bearing deposits are priced off of short-term market rates, the Company is benefiting from the impact of these lower market rates. See "Overview – Looking Forward: 2015 and Beyond" for a discussion of factors influencing the Company's future deposit rates and their impact on net interest margin.

Section 627 of the Dodd-Frank Act repealed Regulation Q effective July 21, 2011, thereby eliminating the prohibition on the payment of interest on demand deposits. Given the historically low rate environment since then, this change has not had any material impact on the Company. However, when rates begin to rise this may impact the Company's cost of deposits, particularly business checking accounts.

2013 Compared to 2012

Net interest income increased 0.4% to $73.6 million during 2013. On a fully tax equivalent basis, net interest income increased 0.3% and totaled $75.0 million during 2013 compared to $74.8 million for 2012. As more fully discussed below, the increase in net interest income was primarily due to an increase in average earning assets offset somewhat by a decrease in the net interest margin.

For 2013, the Company's net interest margin was 4.11% compared to 4.23% in 2012. This decrease in net interest margin was due primarily to declining yields on earning assets that exceeded a corresponding drop in funding costs, offset somewhat by an increase in the mix of loans & leases as a percentage of total earning assets.

Average loans & leases totaled $1.3 billion for the year ended December 31, 2013; an increase of $86.2 million compared to the year ended December 31, 2012. Loans & leases increased from 66.9% of average earning assets during 2012 to 69.6% in 2013. Because of the impact of decreases in market interest rates from mid-September 2007 through December 2008, and the continuing low rate environment since then, the year-to-date yield on the loan & lease portfolio declined to 5.11% for the year ended December 31, 2013, compared to 5.56% for the year ended December 31, 2012. This lower yield offset the impact of an increase in average loan & lease balances resulting in interest revenue from loans & leases decreasing 1.3% to $64.9 million for 2013.

Average investment securities decreased $17.2 million in 2013 compared to the average balance during 2012. As a result, tax equivalent interest income on securities decreased $1.1 million to $12.9 million for the year ended December 31, 2013, compared to $14.0 million for the year ended December 31, 2012. The average yield, on a tax equivalent basis, in the investment portfolio was 2.46% in 2013 compared to 2.58% in 2012. This overall decrease in yield was caused primarily by a decrease in the mix of mortgage-backed securities as a percentage of total securities and a decline in the yield on the Company's mortgage-backed securities portfolio due to a shift in mix from 30 year MBS to 10, 15 and 20 year MBS. Net interest income on the Schedule of Year-to-Date Average Balances and Interest Rates is shown on a tax equivalent basis, which is higher than net interest income as reflected on the Consolidated Statements of Income because of adjustments that relate to income on securities that are exempt from federal income taxes.

Average interest-bearing deposits with banks consisted of: (1) $611,000 in Community Reinvestment Act ('CRA') qualified CD's with various banks; and (2) $30.1 million in FRB deposits. The average rate paid on CRA qualified CD's for 2013 was 0.38% and balances with the FRB earn interest at the Fed Funds rate, which has been 0.25% since December 2008. Average interest-bearing deposits with banks for the year ended December 31, 2013, was $30.7 million, a decrease of $12.6 million compared to the average balance for the year ended December 31, 2012. Interest income on interest-bearing deposits with banks for the year ended December 31, 2013, decreased $31,000 to $79,000 from the year ended December 31, 2012.

Average interest-bearing liabilities decreased $6.7 million or 0.5% during the twelve months ended December 31, 2013. Of that decrease: (1) interest-bearing deposits increased $12.9 million; (2) FHLB Advances increased $8.6 million; and (3) securities sold under agreement to repurchase and subordinated debt decreased $28.2 million.

Table of Contents

The $12.9 million increase in average interest-bearing deposits was primarily in lower cost interest-bearing DDA, and savings and money market deposits, which increased $64.7 million since 2012, as higher cost time deposits decreased by $51.7 million. See "Financial Condition – Deposits" for a discussion of trends in the Company's deposit base. Total interest expense on deposits was $2.5 million for 2013 as compared to $3.7 million for 2012. The average rate paid on interest-bearing deposits was 0.20% in 2013 and 0.29% in 2012. Since most of the Company's interest-bearing deposits are priced off of short-term market rates, the Company is benefiting from the impact of these lower market rates.

Provision and Allowance for Credit Losses

As a financial institution that assumes lending and credit risks as a principal element of its business, credit losses will be experienced in the normal course of business. The Company has established credit management policies and procedures that govern both the approval of new loans & leases and the monitoring of the existing portfolio. The Company manages and controls credit risk through comprehensive underwriting and approval standards, dollar limits on loans & leases to one borrower (the term "borrower" is used herein to describe a customer who has entered into either a loan or lease transaction), and by restricting loans & leases made primarily to its principal market area where management believes it is best able to assess the applicable risk. Additionally, management has established guidelines to ensure the diversification of the Company's credit portfolio such that even within key portfolio sectors such as real estate or agriculture, the portfolio is diversified across factors such as location, building type, crop type, etc. See "Item 7A. Quantitative and Qualitative Disclosures About Market Risk – Credit Risk." Management reports regularly to the Board of Directors regarding trends and conditions in the loan & lease portfolio and regularly conducts credit reviews of individual loans & leases. Loans & leases that are performing but have shown some signs of weakness are subject to more stringent reporting and oversight.

Allowance for Credit Losses

The allowance for credit losses is an estimate of probable incurred credit losses inherent in the Company's loan & lease portfolio as of the balance sheet date. The allowance is established through a provision for credit losses, which is charged to expense. Additions to the allowance are expected to maintain the adequacy of the total allowance after credit losses and loan & lease growth. Credit exposures determined to be uncollectible are charged against the allowance. Cash received on previously charged off amounts is recorded as a recovery to the allowance. The overall allowance consists of three primary components: specific reserves related to impaired loans & leases; general reserves for inherent losses related to loans & leases that are not impaired; and an unallocated component that takes into account the imprecision in estimating and allocating allowance balances associated with macro factors.

A loan or lease is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts due, including principal and interest, according to the contractual terms of the original agreement. Loans & leases determined to be impaired are individually evaluated for impairment. When a loan or lease is impaired, the Company measures impairment based on the present value of expected future cash flows discounted at the loan's or lease's effective interest rate, except that as a practical expedient, it may measure impairment based on a loan's or lease's observable market price, or the fair value of the collateral if the loan or lease is collateral dependent. A loan or lease is collateral dependent if the repayment of the loan or lease is expected to be provided solely by the underlying collateral.

A restructuring of a loan or lease constitutes a troubled debt restructuring ("TDR") under ASC 310-40, if the Company for economic or legal reasons related to the borrower's financial difficulties grants a concession to the borrower that it would not otherwise consider. Restructured loans or leases typically present an elevated level of credit risk as the borrowers are not able to perform according to the original contractual terms. If the restructured loan or lease was current on all payments at the time of restructure and management reasonably expects the borrower will continue to perform after the restructure, management may keep the loan or lease on accrual. Loans & leases that are on nonaccrual status at the time they become TDR, remain on nonaccrual status until the borrower demonstrates a sustained period of performance, which the Company generally believes to be six consecutive months of payments, or equivalent. A loan or lease can be removed from TDR status if it was restructured at a market rate in a prior calendar year and is currently in compliance with its modified terms. However, these loans or leases continue to be classified as impaired and are individually evaluated for impairment.

The determination of the general reserve for loans or leases that are collectively evaluated for impairment is based on estimates made by management, to include, but not limited to, consideration of historical losses by portfolio segment, internal asset classifications, and qualitative factors that include economic trends in the Company's service areas, industry experience and trends, geographic concentrations, estimated collateral values, the Company's underwriting policies, the character of the loan & lease portfolio, and probable losses inherent in the portfolio taken as a whole.

The Company maintains a separate allowance for each portfolio segment (loan & lease type). These portfolio segments include: (1) commercial real estate; (2) agricultural real estate; (3) real estate construction (including land and development loans); (4) residential 1st mortgages; (5) home equity lines and loans; (6) agricultural; (7) commercial; (8) consumer & other; and (9) equipment leases. See "Financial Condition – Loans & Leases" for examples of loans & leases made by the Company. The allowance for credit losses attributable to each portfolio segment, which includes both impaired loans & leases and loans & leases that are not impaired, is combined to determine the Company's overall allowance, which is included on the consolidated balance sheet.

The Company assigns a risk rating to all loans & leases and periodically performs detailed reviews of all such loans & leases over a certain threshold to identify credit risks and assess overall collectability. For smaller balance loans & leases, such as consumer and residential real estate, a credit grade is established at inception, and then updated only when the loan or lease becomes contractually delinquent or when the borrower requests a modification. For larger balance loans, management monitors and analyzes the financial condition of borrowers and guarantors, trends in the industries in which borrowers operate and the fair values of collateral securing these loans & leases. These credit quality indicators are used to assign a risk rating to each individual loan or lease. These risk ratings are also subject to examination by independent specialists engaged by the Company. The risk ratings can be grouped into five major categories, defined as follows:

Pass – A pass loan or lease is a strong credit with no existing or known potential weaknesses deserving of management's close attention.

Special Mention – A special mention loan or lease has potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the loan or lease position at some future date. Special mention loans & leases are not adversely classified and do not expose the Company to sufficient risk to warrant adverse classification.

Substandard – A substandard loan or lease is not adequately protected by the current financial condition and paying capacity of the borrower or the value of the collateral pledged, if any. Loans or leases classified as substandard have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. Well-defined weaknesses include a project's lack of marketability, inadequate cash flow or collateral support, failure to complete construction on time or the project's failure to fulfill economic expectations. They are characterized by the distinct possibility that the Company will sustain some loss if the deficiencies are not corrected.

Doubtful – Loans or leases classified doubtful have all the weaknesses inherent in those classified as substandard with the added characteristic that the weaknesses make collection or liquidation in full, based on currently known facts, conditions and values, highly questionable or improbable.

Loss – Loans or leases classified as loss are considered uncollectible. Once a loan or lease becomes delinquent and repayment becomes questionable, the Company will address collateral shortfalls with the borrower and attempt to obtain additional collateral. If this is not forthcoming and payment in full is unlikely, the Bank will estimate its probable loss and immediately charge-off some or all of the balance.

The general reserve component of the allowance for credit losses also consists of reserve factors that are based on management's assessment of the following for each portfolio segment: (1) inherent credit risk; (2) historical losses; and (3) other qualitative factors. These reserve factors are inherently subjective and are driven by the repayment risk associated with each portfolio segment described below:

Commercial Real Estate – Commercial real estate mortgage loans are generally considered to possess a higher inherent risk of loss than the Company's commercial, agricultural and consumer loan types. Adverse economic developments or an overbuilt market impact commercial real estate projects and may result in troubled loans. Trends in vacancy rates of commercial properties impact the credit quality of these loans. High vacancy rates reduce operating revenues and the ability for properties to produce sufficient cash flow to service debt obligations.

Table of Contents

Real Estate Construction – Real estate construction loans, including land loans, are generally considered to possess a higher inherent risk of loss than the Company's commercial, agricultural and consumer loan types. A major risk arises from the necessity to complete projects within specified cost and time lines. Trends in the construction industry significantly impact the credit quality of these loans, as demand drives construction activity. In addition, trends in real estate values significantly impact the credit quality of these loans, as property values determine the economic viability of construction projects.

Commercial – These loans are generally considered to possess a moderate inherent risk of loss because they are shorter-term; typically made to relationship customers; generally underwritten to existing cash flows of operating businesses; and may be collateralized by fixed assets, inventory and/or accounts receivable. Debt coverage is provided by business cash flows and economic trends influenced by unemployment rates and other key economic indicators are closely correlated to the credit quality of these loans.

Agricultural Real Estate and Agricultural – These loans are generally considered to possess a moderate inherent risk of loss since they are typically made to relationship customers and are secured by crop production, livestock and related real estate. These loans are vulnerable to two risk factors that are largely outside the control of Company and borrowers: commodity prices and weather conditions.

Leases – Equipment leases are generally considered to possess a moderate inherent risk of loss. As Lessor, the company is subject to both the credit risk of the borrower and the residual value risk of the equipment. Credit risks are underwritten using the same credit criteria the Company would use when making an equipment term loan. Residual value risk is managed through the use of qualified, independent appraisers that establish the residual values the Company uses in structuring a lease.

Residential 1st Mortgages and Home Equity Lines and Loans – These loans are generally considered to possess a low inherent risk of loss, although this is not always true as evidenced by the weakness in residential real estate values over the past five years. The degree of risk in residential real estate lending depends primarily on the loan amount in relation to collateral value, the interest rate and the borrower's ability to repay in an orderly fashion. Economic trends determined by unemployment rates and other key economic indicators are closely correlated to the credit quality of these loans. Weak economic trends indicate that the borrowers' capacity to repay their obligations may be deteriorating.

Consumer & Other – A consumer installment loan portfolio is usually comprised of a large number of small loans scheduled to be amortized over a specific period. Most installment loans are made for consumer purchases. Economic trends determined by unemployment rates and other key economic indicators are closely correlated to the credit quality of these loans. Weak economic trends indicate that the borrowers' capacity to repay their obligations may be deteriorating.

In addition, the Company's and Bank's regulators, including the FRB, DBO and FDIC, as an integral part of their examination process, review the adequacy of the allowance. These regulatory agencies may require additions to the allowance based on their judgment about information available at the time of their examinations.

Provision for Credit Losses

Changes in the provision for credit losses between years are the result of management's evaluation, based upon information currently available, of the adequacy of the allowance for credit losses relative to factors such as the credit quality of the loan & lease portfolio, loan & lease growth, current credit losses, and the prevailing economic climate and its effect on borrowers' ability to repay loans & leases in accordance with the terms of the notes.

The Central Valley of California was one of the hardest hit areas in the country during the recession. In many areas, housing prices declined as much as 60% and unemployment reached 15% or more. Although the economy has stabilized throughout most of the Central Valley, housing prices for the most part have not recovered significantly and unemployment levels remain well above those in other areas of the state and country. While, in management's opinion, the Company's levels of net charge-offs and non-performing assets as of December 31, 2014, compare very favorably to our peers at the present time, carefully managing credit risk remains a key focus of the Company.

Table of Contents

The state of California has experienced drought conditions during much of 2013 and 2014. Importantly, most of the Company’s agricultural customers have access to their own ground water supplies and, therefore, are not as dependent on the delivery of surface water as growers in other parts of California. Although Management continues to believe that current conditions will not have a material impact on credit quality during 2015, the lack of rain will have a continuing adverse impact on our agricultural customers’ operating costs, crop yields and crop quality. The longer the drought continues, the more significant this impact will become, particularly if ground water levels reach critical stage.

The provision for credit losses totaled $1.2 million in 2014 compared to $425,000 in 2013 and $1.9 million in 2012. Net charge-offs during 2014 were $48,000 compared to $368,000 in 2013 and $650,000 in 2012. Net charge-offs represented 0.0% of average loans & leases during 2014, a level that in management’s opinion compares very favorably to the Company’s peers at the present time. The increase in the provision over the past year reflects the growth that occurred in the loan portfolio during 2014. See “Overview – Looking Forward: 2015 and Beyond,” “Critical Accounting Policies and Estimates – Allowance for Credit Losses” and “Item 7A. Quantitative and Qualitative Disclosures About Market Risk-Credit Risk.”

Table of Contents

The following tables summarize the activity and the allocation of the allowance for credit losses for the years indicated. (in thousands)

	2014	2013	2012	2011	2010
Allowance for Credit Losses Beginning of Year	$34,274	$34,217	$33,017	$32,261	$29,813
Provision Charged to Expense	1,175	425	1,850	6,775	14,735
Charge-Offs:					
Commercial Real Estate	-	6	-	25	1,629
Agricultural Real Estate	-	575	-	384	559
Real Estate Construction	-	-	-	-	4,095
Residential 1st Mortgages	73	16	152	449	759
Home Equity Lines and Loans	70	91	259	751	310
Agricultural	-	23	294	3,559	916
Commercial	1	60	198	788	4,143
Consumer & Other	132	120	145	190	112
Total Charge-Offs	276	891	1,048	6,146	12,523
Recoveries:					
Commercial Real Estate	11	-	-	-	-
Agricultural Real Estate	-	-	90	18	2
Real Estate Construction	-	-	-	-	-
Residential 1st Mortgages	-	-	53	4	7
Home Equity Lines and Loans	58	115	14	13	-
Agricultural	8	42	61	10	68
Commercial	86	312	117	21	92
Consumer & Other	65	54	63	61	67
Total Recoveries	228	523	398	127	236
Net Charge-Offs	(48)	(368)	(650)	(6,019)	(12,287)
Total Allowance for Credit Losses	$35,401	$34,274	$34,217	$33,017	$32,261
Ratios:					
Allowance for Credit Losses to:					
Total Loans & Leases at Year End	2.06 %	2.46 %	2.74 %	2.83 %	2.74 %
Average Loans & Leases	2.36 %	2.70 %	2.89 %	2.82 %	2.73 %
Consolidated Net Charge-Offs to:					
Total Loans & Leases at Year End	0.00 %	0.03 %	0.05 %	0.52 %	1.04 %
Average Loans & Leases	0.00 %	0.03 %	0.05 %	0.51 %	1.04 %

The table below breaks out year-to-date activity by portfolio segment (in thousands):

December 31, 2014	Commercial Real Estate	Agricultural Real Estate	Real Estate Construction	Residential 1st Mortgages	Home Equity Lines & Loans	Agricultural	Commercial	Consumer & Other	Leases	Unallocated	Total
Year-To-Date Allowance for Credit Losses:											
Beginning Balance- January 1, 2014	$5,178	$3,576	$654	$1,108	$2,767	$12,205	$5,697	$176	$639	$2,274	$34,274
Charge-Offs	-	-	-	(73)	(70)	-	(1)	(132)	-	-	(276)

Recoveries	11	-	-	-	58	8	86	65	-	-	228
Provision	2,653	609	1,015	(13)	(329)	(6,109)	2,413	109	1,572	(745)	1,175
Ending Balance-											
December 31, 2014	$7,842	$4,185	$1,669	$1,022	$2,426	$6,104	$8,195	$218	$2,211	$1,529	$35,401

Overall, the Allowance for Credit Losses as of December 31, 2014 increased $1.1 million from December 31, 2013. The allowance allocated to the following categories of loans changed as follows during the twelve months ended December 31, 2014:

40

Table of Contents

- Commercial Real Estate, Agricultural Real Estate, Real Estate Construction, Commercial and Lease allowance balances increased, primarily as a result of increased loan and lease balances.

- Agricultural allowance balances decreased $6.1 million, primarily due to the impact on reserve factors of an improvement in the overall credit quality of the portfolio during the past three years.

- Unallocated allowance balances decreased $745,000 due to the imprecision in estimating and allocating allowance balances associated with macro factors such as: (1) the continuing sluggish economic conditions in the Central Valley (see Item 1A. Risk Factors – Risks Associated With Our Business - Continuing Difficult Economic Conditions In Our Service Areas Could Adversely Affect Our Operations And/Or Cause Us To Sustain Losses); and (2) the long term impact of drought conditions currently being experienced in California (see Item 1A. Risk Factors – Risks Associated With Our Business - Our Financial Results Can Be Impacted By The Cyclicality and Seasonality Of Our Agricultural Business And The Risks Related Thereto).

	Allowance Allocation at December 31,														
(in thousands)	2014 Amount	Percent of Loans in Each Category to Total Loans		2013 Amount	Percent of Loans in Each Category to Total Loans		2012 Amount	Percent of Loans in Each Category to Total Loans		2011 Amount	Percent of Loans in Each Category to Total Loans		2010 Amount	Percent of Loans in Each Category to Total Loans	
Commercial Real Estate	$7,842	28.9	%	$5,178	29.5	%	$6,464	28.2	%	$5,823	26.4	%	$7,631	27.0	%
Agricultural Real Estate	4,185	20.8	%	3,576	23.6	%	2,877	25.0	%	2,583	24.0	%	1,539	21.6	%
Real Estate Construction	1,669	5.6	%	654	3.0	%	986	2.6	%	1,933	2.5	%	2,160	3.2	%
Residential 1st Mortgages	1,022	10.0	%	1,108	10.9	%	1,219	11.2	%	1,251	9.2	%	1,164	8.8	%
Home Equity Lines and Loans	2,426	1.9	%	2,767	2.5	%	3,235	3.4	%	3,746	4.4	%	3,724	5.0	%
Agricultural	6,104	16.4	%	12,205	18.4	%	10,437	17.7	%	8,127	18.6	%	6,733	19.6	%
Commercial	8,195	13.5	%	5,697	10.8	%	7,963	11.5	%	8,733	14.2	%	9,084	14.0	%
Consumer & Other	218	0.3	%	176	0.4	%	182	0.4	%	207	0.7	%	216	0.8	%
Leases	2,211	2.6	%	639	0.9	%	-	0.0	%	-	0.0	%	-	0.0	%
Unallocated	1,529			2,274			854			614			10		
Total	$35,401	100.0	%	$34,274	100.0	%	$34,217	100.0	%	$33,017	100.0	%	$32,261	100.0	%

As of December 31, 2014, the allowance for credit losses was $35.4 million, which represented 2.06% of the total loan & lease balance. At December 31, 2013, the allowance for credit losses was $34.3 million or 2.46% of the total loan & lease balance. After reviewing all factors above, based upon information currently available, management concluded that the allowance for credit losses as of December 31, 2014, was adequate.

Non-Interest Income

Non-interest income includes: (1) service charges and fees from deposit accounts; (2) net gains and losses from investment securities; (3) increases in the cash surrender value of bank owned life insurance; (4) debit card and ATM fees; (5) net gains and losses on non-qualified deferred compensation plan investments; and (6) fees from other miscellaneous business services. See “Overview – Looking Forward: 2015 and Beyond.”

2014 Compared to 2013

Non interest income totaled $14.3 million, a decrease of $1.6 million or 10.1% from non-interest income of $15.9 million for 2013.

Service charges on deposit accounts totaled $3.9 million, a decrease of $427,000 or 9.8% from service charges on deposit accounts of $4.4 million in 2013. This was due primarily to a decrease in fees related to the Company’s Overdraft Privilege Service.

Net gain on investment securities was $90,000 in 2014 compared to a net loss of $229,000 for 2013. See “Financial Condition-Investment Securities” for a discussion of the Company’s investment strategy.

Table of Contents

Net gains on deferred compensation investments were $2.1 million in 2014 compared to net gains of $3.4 million in 2013. See Note 16, located in "Item 8. Financial Statements and Supplementary Data" for a description of these plans. Balances in non-qualified deferred compensation plans may be invested in financial instruments whose market value fluctuates based upon trends in interest rates and stock prices. Although Generally Accepted Accounting Principles require these investment gains/losses be recorded in non-interest income, an offsetting entry is also required to be made to non-interest expense resulting in no effect on the Company's net income.

Other non-interest income was $3.2 million, a decrease of $306,000 or 8.9% over 2013. This decrease was primarily due to the gain on sale of our Modesto Village branch building in the amount of $706,000, which took place in 2013. The absence of this gain in 2014 was partially offset by a $483,000 gain on the early termination of a lease agreement.

2013 Compared to 2012

Non interest income totaled $15.9 million, an increase of $1.8 million or 13.0% from non-interest income of $14.1 million for 2012.

Service charges on deposit accounts totaled $4.4 million, a decrease of $541,000 or 11.1% from service charges on deposit accounts of $4.9 million in 2012. This was due primarily to a decrease in fees related to the Company's Overdraft Privilege Service.

Net loss on investment securities was $229,000 in 2013 compared to a net gain of $158,000 for 2012.

Debit Card and ATM fees totaled $3.1 million, an increase of $131,000 or 4.5% over fees in 2012. These are: (1) fees paid to the Company by card associations and networks (such as Visa, Pulse, etc. when the Company's cardholders (ATM Card or Debit Card) use their cards to complete transactions; (2) fees earned by the Company when non-customers use our ATM's; and (3) monthly transaction fees paid by our customers.

Net gains on deferred compensation investments were $3.4 million in 2013 compared to net gains of $1.7 million in 2012.

Other non-interest income was $3.5 million, an increase of $925,000 or 35.6% over 2012. This increase was primarily due to: (1) the gain on sale of our Modesto Village branch building in the amount of $706,000; and (2) an increase of $227,000 in FHLB cash dividends.

Non-Interest Expense

Non-interest expense for the Company includes expenses for: (1) salaries and employee benefits; (2) net gains and losses on non-qualified deferred compensation plan investments; (3) occupancy; (4) equipment; (5) supplies; (6) legal fees; (7) professional services; (8) data processing; (9) marketing; (10) deposit insurance; and (11) other miscellaneous expenses.

2014 Compared to 2013

Overall, non-interest expense totaled $51.4 million, an increase of $496,000 or 1.0% for the year ended December 31, 2014.

Salaries and employee benefits increased $2.8 million or 8.3% primarily related to: (1) new staff added for the then loan production offices in Walnut Creek and Irvine; (2) bank wide raises; and (3) increased medical insurance premiums.

Net Gains on deferred compensation investments were $2.1 million in 2014 compared to net gains of $3.4 million in 2013. See Note 16, located in "Item 8. Financial Statements and Supplementary Data" for a description of these plans. Balances in non-qualified deferred compensation plans may be invested in financial instruments whose market value fluctuates based upon trends in interest rates and stock prices. Although Generally Accepted Accounting Principles require these investment gains/losses be recorded in non-interest expense, an offsetting entry is also required to be made to non-interest income resulting in no effect on the Company's net income.

Table of Contents
Occupancy expense in 2014 totaled $2.7 million, an increase of $177,000 or 7.0% from 2013. This increase is primarily due to lease payments related to our two new branches in Irvine and Walnut Creek, CA.

Legal fee expense decreased $441,000 or 77.5% from 2013. This decrease is primarily related to reimbursement of certain prior years' legal fees by the Company's insurance company.

Other non-interest expense decreased $869,000, or 12.4%, to $6.1 million in 2014 compared to $7.0 million in 2013, primarily due to a $681,000 drop in operating losses.

2013 Compared to 2012
Overall, non-interest expense totaled $50.9 million, an increase of $2.6 million or 5.4% for the year ended December 31, 2013.

Salaries and employee benefits increased $2.0 million or 6.4% primarily related to: (1) new staff added for the LPO's in Walnut Creek and Irvine; (2) bank wide raises; and (3) increased medical insurance premiums.

Net Gains on deferred compensation investments were $3.4 million in 2013 compared to net gains of $1.7 million in 2012.

Equipment expense in 2013 totaled $2.8 million, a decrease of $345,000 or 11.0% from 2012. This decrease is primarily due to reduced software maintenance contracts and Americans with Disabilities Act ('ADA') upgrades to all of our ATM machines that took place in 2012.

ORE holding costs in 2013 totaled $91,000, a decrease of $31,000 or 25.4% as compared to $122,000 in 2012. This decrease is primarily due to a decrease in the number of ORE properties the Company owns and stabilization of real estate values.

The Company's total FDIC insurance costs increased $13,000 in 2013 to $981,000, a 1.3% increase from $968,000 in 2012.

Legal fee expense decreased $470,000 or 45.2% from 2012. This decrease is primarily related to the decline in the level of the Company's problem loans.

On June 21, 2012, the Company terminated repurchase agreements with Citigroup resulting in an early termination fee totaling $1.7 million. The Company determined that the time was appropriate to replace these relatively "high-cost" borrowings with short-term FHLB advances at substantially lower rates.

Other non-interest expense increased $1.4 million, or 25.0%, to $7.0 million in 2013 compared to $5.6 million in 2012. During 2013, the Company incurred increased expenses related to employee training, ATM/Debit card activities, consulting services and customer operating losses.

Income Taxes
The provision for income taxes increased $873,000 during 2014. The effective tax rate in 2014 was 37.3% compared to 37.2% in 2013 and 37.5% in 2012. The effective rates were lower than the statutory rate of 42% due primarily to benefits regarding the cash surrender value of life insurance, California enterprise zone interest income exclusion, and tax-exempt interest income on municipal securities and loans.

Current tax law causes the Company's current taxes payable to approximate or exceed the current provision for taxes on the income statement. Three provisions have had a significant effect on the Company's current income tax liability: (1) the restrictions on the deductibility of credit losses; (2) deductibility of pension and other long-term employee benefits only when paid; and (3) the statutory deferral of deductibility of California franchise taxes on the Company's federal return.

Table of Contents
Financial Condition

Investment Securities and Federal Funds Sold
The investment portfolio provides the Company with an income alternative to loans & leases. The debt securities in the Company's investment portfolio have historically been comprised primarily of: (1) mortgage-backed securities issued by federal government-sponsored entities; (2) debt securities issued by government agencies and government-sponsored entities; and (3) investment grade bank-qualified municipal bonds. However, during 2012, when loan demand lagged deposit growth resulting in significant liquidity, the Company began to selectively add investment grade corporate securities (floating rate and fixed rate with maturities less than 5 years) to the portfolio in order to obtain yields that exceed government agency securities of equivalent maturity without subjecting the Company to the interest rate risk associated with mortgage-backed securities. This portfolio of corporate securities was sold during the 3rd quarter of 2014 in order to fund the Company's increase in loan balances.

The Company's investment portfolio at December 31, 2014 was $430.4 million compared to $473.1 million at December 31, 2013, a decrease of $42.7 million or 9.0%. To protect against future increases in market interest rates, while at the same time generating some reasonable level of current yields, the Company has invested most of its available funds in either shorter term government agency & government-sponsored entity securities and shorter term (10, 15, and 20 year) mortgage-backed securities.

The Company's total investment portfolio currently represents 18.2% of the Company's total assets as compared to 22.8% at December 31, 2013.

As of December 31, 2014 the Company held $61.7 million of municipal investments, of which $48.3 million were bank-qualified municipal bonds, all classified as held-to-maturity ("HTM"). The continuing financial problems being experienced by certain municipalities, along with the financial stresses exhibited by some of the large monoline bond insurers, has increased the overall risk associated with bank-qualified municipal bonds. This situation caused the Company not to purchase any municipal bonds between late 2006 and year-end 2011. However, during the first quarter of 2012 the Company began investing in bank-qualified municipals that were rated AA or better. In order to comply with Section 939A of the Dodd-Frank Act, the Company performs its own credit analysis on new purchases of municipal bonds. As of December 31, 2014, ninety-seven percent of the Company's bank-qualified municipal bond portfolio is rated at either the issue or issuer level, and all of these ratings are "investment grade." The Company monitors the status of all municipal investments with particular attention paid to the approximately three percent ($1.4 million) of the portfolio that is not rated, and at the current time does not believe any of them to be exhibiting financial problems that could result in a loss in any individual security. In June 2014, the Company sold $375,000 of municipal bonds from a single issuer. The Company took this action under the provisions of ASC 320-10-25-6(a), which allow for the sale of HTM securities where there is "evidence of a significant deterioration in the issuer's creditworthiness."

Not included in the investment portfolio are interest bearing deposits with banks and overnight investments in Federal Funds Sold. Interest bearing deposits with banks consist of FRB deposits. The FRB currently pays interest on the deposits that banks maintain in their FRB accounts, whereas historically banks had to sell these Federal Funds to other banks in order to earn interest. Since balances at the FRB are effectively risk free, the Company elected to maintain its excess cash at the FRB. Interest bearing deposits with banks totaled $34.8 million at December 31, 2014 and $42.7 million at December 31, 2013.

The Company classifies its investments as held-to-maturity, trading, or available-for-sale ("AFS"). Securities are classified as held-to-maturity and are carried at amortized cost when the Company has the intent and ability to hold the securities to maturity. Trading securities are securities acquired for short-term appreciation and are carried at fair value, with unrealized gains and losses recorded in non-interest income. As of December 31, 2014 and December 31, 2013, there were no securities in the trading portfolio. Securities classified as available-for-sale include securities, which may be sold to effectively manage interest rate risk exposure, prepayment risk, satisfy liquidity demands and other factors. These securities are reported at fair value with aggregate, unrealized gains or losses excluded from income and included as a separate component of shareholders' equity, net of related income taxes.

Table of Contents

Investment Portfolio

The following table summarizes the balances and distributions of the investment securities held on the dates indicated.

December 31: (in thousands)	Available for Sale 2014	Held to Maturity	Available for Sale 2013	Held to Maturity	Available for Sale 2012	Held to Maturity
Government Agency & Government Sponsored Entities	$78,109	$ -	$28,436	$ -	$26,823	$ -
Obligations of States and Political Subdivisions - Non-Taxable	-	61,716	-	65,685	5,665	65,694
Mortgage Backed Securities	287,948	-	324,929	45	352,772	484
Corporate Securities	-	-	49,380	-	22,558	-
Other	485	2,147	1,894	2,775	10,173	2,214
Total Book Value	$366,542	$63,863	$404,639	$68,505	$417,991	$68,392
Fair Value	$366,542	$64,635	$404,639	$68,689	$417,991	$70,697

Analysis of Investment Securities Available-for-Sale

The following table is a summary of the relative maturities and yields of the Company's investment securities Available-for-Sale as of December 31, 2014. Non-taxable Obligations of States and Political Subdivisions have been calculated on a fully taxable equivalent basis.

December 31, 2014 (in thousands)	Fair Value	Average Yield	
Government Agency & Government Sponsored Entities			
One year or less	$76,985	0.18	%
After one year through five years	1,124	2.82	%
Total Government Agency & Government Sponsored Entities	78,109	0.22	%
Other			
One year or less	485	0.68	%
Total Other Securities	485	0.68	%
Mortgage Backed Securities	287,948	2.26	%
Total Investment Securities Available-for-Sale	$366,542	1.82	%

Note: The average yield for floating rate securities is calculated using the current stated yield.

Analysis of Investment Securities Held-to-Maturity

The following table is a summary of the relative maturities and yields of the Company's investment securities Held-to-Maturity as of December 31, 2014. Non-taxable Obligations of States and Political Subdivisions have been calculated on a fully taxable equivalent basis.

December 31, 2014 (in thousands)	Book Value	Average Yield	
Obligations of States and Political Subdivisions - Non-Taxable			
One year or less	$600	5.35	%
After one year through five years	16,426	6.20	%
After five years through ten years	9,845	5.00	%
After ten years	34,845	4.83	%
Total Obligations of States and Political Subdivisions - Non-Taxable	61,716	5.23	%
Other			
After one year through five years	2,147	0.57	%

Total Other Securities	2,147	0.27	%
Total Investment Securities Held-to-Maturity	$63,863	5.06	%

Table of Contents

Loans & Leases

Loans & Leases can be categorized by borrowing purpose and use of funds. Common examples of loans & leases made by the Company include:

Commercial and Agricultural Real Estate - These are loans secured by farmland, commercial real estate, multifamily residential properties, and other non-farm, non-residential properties within our market area. Commercial mortgage term loans can be made if the property is either income producing or scheduled to become income producing based upon acceptable pre-leasing, and the income will be the Bank's primary source of repayment for the loan. Loans are made both on owner occupied and investor properties; generally do not exceed 15 years (and may have pricing adjustments on a shorter timeframe); have debt service coverage ratios of 1.00 or better with a target of greater than 1.20; and fixed rates that are most often tied to treasury indices with an appropriate spread based on the amount of perceived risk in the loan.

Real Estate Construction - These are loans for development and construction (the Company generally requires the borrower to fund the land acquisition) and are secured by commercial or residential real estate. These loans are generally made only to experienced local developers with whom the Bank has a successful track record; for projects in our service area; with Loan To Value (LTV) below 75%; and where the property can be developed and sold within 2 years. Commercial construction loans are made only when there is a written take-out commitment from the Bank or an acceptable financial institution or government agency. Most acquisition, development and construction loans are tied to the prime rate with an appropriate spread based on the amount of perceived risk in the loan.

Residential 1st Mortgages - These are loans primarily made on owner occupied residences; generally underwritten to income and LTV guidelines similar to those used by FNMA and FHLMC; however, we will make loans on rural residential properties up to 20 acres. Most residential loans have terms from ten to twenty years and carry fixed rates priced off of treasury rates. The Company has always underwritten mortgage loans based upon traditional underwriting criteria and does not make loans that are known in the industry as “subprime,” “no or low doc,” or “stated income.”

Home Equity Lines and Loans - These are loans made to individuals for home improvements and other personal needs. Generally, amounts do not exceed $250,000; Combined Loan To Value (CLTV) does not exceed 80%; FICO scores are at or above 670; Total Debt Ratios do not exceed 43%; and in some situations the Company is in a 1st lien position.

Agricultural - These are loans and lines of credit made to farmers to finance agricultural production. Lines of credit are extended to finance the seasonal needs of farmers during peak growing periods; are usually established for periods no longer than 12 to 24 months; are often secured by general filing liens on livestock, crops, crop proceeds and equipment; and are most often tied to the prime rate with an appropriate spread based on the amount of perceived risk in the loan. Term loans are primarily made for the financing of equipment, expansion or modernization of a processing plant, or orchard/vineyard development; have maturities from five to seven years; and fixed rates that are most often tied to treasury indices with an appropriate spread based on the amount of perceived risk in the loan.

Commercial - These are loans and lines of credit to businesses that are sole proprietorships, partnerships, LLC’s and corporations. Lines of credit are extended to finance the seasonal working capital needs of customers during peak business periods; are usually established for periods no longer than 12 to 24 months; are often secured by general filing liens on accounts receivable, inventory and equipment; and are most often tied to the prime rate with an appropriate spread based on the amount of perceived risk in the loan. Term loans are primarily made for the financing of equipment, expansion or modernization of a plant or purchase of a business; have maturities from five to seven years; and fixed rates that are most often tied to treasury indices with an appropriate spread based on the amount of perceived risk in the loan.

Consumer - These are loans to individuals for personal use, and primarily include loans to purchase automobiles or recreational vehicles, and unsecured lines of credit. The Company has a very minimal consumer loan portfolio, and loans are primarily made as an accommodation to deposit customers.

Table of Contents

Leases –These are leases to businesses or individuals, for the purpose of financing the acquisition of equipment. They can be either “finance leases” where the lessee retains the tax benefits of ownership but obtains 100% financing on their equipment purchases; or “true tax leases” where the Company, as lessor, places reliance on equipment residual value and in doing so obtains the tax benefits of ownership. Leases typically have a maturity of three to ten years, and fixed rates that are most often tied to treasury indices with an appropriate spread based on the amount of perceived risk. Credit risks are underwritten using the same credit criteria the Company would use when making an equipment term loan. Residual value risk is managed through the use of qualified, independent appraisers that establish the residual values the Company uses in structuring a lease.

The Company accounts for leases with Investment Tax Credits (ITC) under the deferred method as established in Accounting Standard Codification (ASC) 740-10. ITC are viewed and accounted for as a reduction of the cost of the related assets and presented as deferred income on the Company’s financial statement.

See “Item 7A. Quantitative and Qualitative Disclosures About Market Risk-Credit Risk” for a discussion about the credit risks the Company assumes and its overall credit risk management practices.

Each loan or lease type involves risks specific to the: (1) borrower; (2) collateral; and (3) loan & lease structure. See “Results of Operations - Provision and Allowance for Credit Losses” for a more detailed discussion of risks by loan & lease type. The Company’s current underwriting policies and standards are designed to mitigate the risks involved in each loan & lease type. The Company’s policies require that loans & leases are approved only to those borrowers exhibiting a clear source of repayment and the ability to service existing and proposed debt. The Company’s underwriting procedures for all loan & lease types require careful consideration of the borrower, the borrower’s financial condition, the borrower’s management capability, the borrower’s industry, and the economic environment affecting the loan or lease.

Most loans & leases made by the Company are secured, but collateral is the secondary or tertiary source of repayment; cash flow is our primary source of repayment. The quality and liquidity of collateral are important and must be confirmed before the loan is made.

In order to be responsive to borrower needs, the Company prices loans & leases: (1) on both a fixed rate and adjustable rate basis; (2) over different terms; and (3) based upon different rate indices; as long as these structures are consistent with the Company’s interest rate risk management policies and procedures. See “Item 7A. Quantitative and Qualitative Disclosures About Market Risk-Interest Rate Risk.”

Overall, the Company's loan & lease portfolio at December 31, 2014, increased $324.0 million or 23.3% from December 31, 2013. This increase has occurred despite the continuing sluggish economic conditions in the Central Valley of California and is a result of: (1) the Company’s intensified business development efforts directed toward credit-qualified borrowers; (2) entry into the equipment leasing business; and (3) expansion of our service area into Walnut Creek and Irvine. No assurances can be made that this growth in the loan & lease portfolio will continue.

Table of Contents

The following table sets forth the distribution of the loan & lease portfolio by type and percent as of December 31 of the years indicated.

	2014		2013		2012		2011		2010	
(in thousands)	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percen
Commercial Real Estate	$495,316	28.9 %	$411,037	29.5 %	$353,109	28.3 %	$307,670	26.4 %	$318,341	27.0
Agricultural Real Estate	357,207	20.8 %	328,264	23.6 %	311,992	25.0 %	280,139	24.0 %	254,575	21.6
Real Estate Construction	96,519	5.6 %	41,092	3.0 %	32,680	2.6 %	29,607	2.5 %	37,486	3.2
Residential 1st Mortgages	171,880	10.0 %	151,292	10.9 %	140,257	11.2 %	107,421	9.2 %	103,574	8.8
Home Equity Lines and Loans	33,017	1.9 %	35,477	2.5 %	42,042	3.4 %	50,956	4.4 %	58,971	5.0
Agricultural	281,963	16.4 %	256,414	18.4 %	221,032	17.7 %	217,227	18.6 %	231,150	19.6
Commercial	230,819	13.5 %	150,398	10.8 %	143,293	11.5 %	165,089	14.2 %	165,263	14.0
Consumer & Other	4,719	0.3 %	5,052	0.4 %	5,058	0.3 %	6,935	0.7 %	8,712	0.8
Leases	44,217	2.6 %	12,733	0.9 %	-	0.0 %	-	0.0 %	-	0.0
Total Gross Loans & Leases	1,715,657	100.0%	1,391,759	100.0%	1,249,463	100.0%	1,165,044	100.0%	1,178,072	100.0
Less: Unearned Income	3,413		3,523		2,561					