FARMERS & MERCHANTS BANCORP
Form 10-K
March 15, 2011

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K

x ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF
THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2010

OR

o 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 o No x

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 o No x

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 x No o

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

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. x

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

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

The aggregate market value of the Registrant's common stock held by non-affiliates on June 30, 2010 (based on the last reported trade on June 30, 2010) was $260,831,240.

The number of shares of Common Stock outstanding as of February 28, 2011: 779,424

Documents Incorporated by Reference:
Portions of the definitive Proxy Statement for the 2011 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.

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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: (i) the current economic downturn and turmoil in financial markets and the response of federal and state regulators thereto; (ii) the effect of changing regional and national economic conditions including the housing market in the Central Valley of California; (iii) significant changes in interest rates and prepayment speeds; (iv) credit risks of lending and investment activities; (v) changes in federal and state banking laws or regulations; (vi) competitive pressure in the banking industry; (vii) changes in governmental fiscal or monetary policies; (viii) 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; and (ix) 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 of Lodi. The Bank was incorporated under the laws of the State of California and was licensed by the California Department of Financial Institutions as a state-chartered bank. Farmers & Merchants’ first venture out of Lodi occurred when the Galt office was opened in 1948. Shortly thereafter branches were opened in Linden, Modesto and South Sacramento. In 1957, the Bank’s name was changed to Farmers & Merchants Bank of Central California.

The Bank continued expansion in the Lodi market area and also acquired three offices in Turlock and Hilmar in 1985. The service area was next expanded by opening a branch in Elk Grove and a third office in Modesto. The year 2002 saw the opening of the Company’s first branch in the city of Stockton. In 2003, the Bank opened its fourth office in Modesto.

A second Galt office was opened in 2005 and a new full-service branch in downtown Sacramento was opened in early 2006. In late 2006, the Company opened its sixth Lodi office and its first commercial branch in Stockton. The downtown Turlock branch was relocated to a new facility in April 2008 and the Company’s first branch in Merced was opened in February 2009.

In addition to the preceding 22 full-service branches, the Bank serves the needs of its customers through two stand-alone ATM’s located on the grounds of the Lodi Grape Festival and California State University-Stanislaus. In 2007, the Bank began offering certain products over the internet at www.fmbonline.com.

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, 2010, consisted of 779,424 shares of common stock, $0.01 par value and no shares of preferred stock issued. The Bank is the Company’s principal asset.

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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 most 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 advanced 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-fed member bank subject to the regulation and examination of the California Department of Financial Institutions ("DFI") and the Federal Deposit Insurance Corporation ("FDIC").

Service Area

The Company services the mid Central Valley of California, including Sacramento, San Joaquin, Stanislaus and Merced counties, with 22 banking offices and two stand-alone ATM's. This area encompasses:

- Sacramento MSA, with branches in Sacramento, Elk Grove and Galt. This MSA has a Population of 2.2 million and a Per Capita Income of approximately $40,200. The MSA includes significant employment in the following sectors: state and local government; agriculture; and trade, transportation and utilities. Unemployment currently stands at 12.5% and has increased 7.8% since 2006. Job growth in the Sacramento MSA has declined 5.4% over the past two years.

- 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 $31,600. 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 17.5% and has increased 10.1% since 2006. Job growth in the Stockton MSA has declined 7.1% over the past two years.

- Modesto MSA, with branches in Modesto and Turlock. This MSA has a Population of 0.5 million and a Per Capita Income of approximately $31,800. 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 17.9% and has increased 10.0% since 2006. Job growth in the Modesto MSA has declined 6.8%

over the past two years.

- Merced MSA with branches in Hilmar and Merced. This MSA has a Population of 0.2 million and a Per Capita Income of approximately $27,700. The MSA includes significant employment in the following sectors: agriculture; state and local government; and trade, transportation and utilities. Unemployment currently stands at 19.4% and has increased10.0% since 2006. Job growth in the Merced MSA has declined 6.8% over the past two years.

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All of the Company's 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" for additional discussion regarding the Company's market conditions.

Through its network of banking offices, the Company emphasizes personalized service along with a full 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 full 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 full complement of lending products, including commercial, real estate construction, agribusiness, installment, credit card, and real estate loans. Commercial products include 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, collection services, lockbox, 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, 2010, the Company employed a total of 306 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.

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.

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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 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, 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 its subsidiaries 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. See "Supervision and Regulation."

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 depositors 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.

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."

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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 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 Gramm-Leach-Bliley Act of 1999 ("GLBA") eliminated many of the restrictions placed on the activities of bank holding companies that become financial holding companies. Among other things, GLBA repealed certain Glass-Steagall Act restrictions on affiliations between banks and securities firms, and amended the BHCA to permit bank holding companies that are financial holding companies to engage in activities, and acquire companies engaged in activities, that are: financial in nature (including insurance underwriting, insurance company portfolio investment, financial advisory, securities underwriting, dealing and market-making, and merchant banking activities); incidental to financial activities; or complementary to financial activities if the FRB determines that they pose no substantial risk to the safety or soundness of depository institutions or the financial system in general. GLBA also permits national banks to engage in activities considered financial in nature through a financial subsidiary, subject to certain conditions and limitations. The Company has not become a financial holding company.

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-fed member bank, is subject to primary supervision, periodic examination and regulation by the DFI 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 DFI 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, 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."

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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 GLBA, in addition to the previous described changes in permissible, non-banking activities permitted to banks, bank holding companies, and financial holding companies, also 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 $33.7 million at December 31, 2010.

The FDIC and the DFI 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 and the DFI 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 which 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 DFI 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, 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).

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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 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.”

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, 2010, 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, the Company and any company with significant trading activity must incorporate a measure for market risk in its regulatory capital calculations.

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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 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.

Deposit Insurance

The deposits of the Bank have historically been insured by the FDIC up to $100,000 per insured depositor, except certain types of retirement accounts, which were insured up to $250,000 per insured depositor. On October 3, 2008, the maximum amount insured under FDIC deposit insurance was temporarily increased from $100,000 to $250,000 per insured depositor. This increase was part of the Emergency Economic Stabilization Act of 2008, and was made permanent with the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the “Dodd-Frank Act”). The Dodd-Frank Act also provides unlimited deposit insurance until January 1, 2013 for non-interest bearing demand transaction accounts.

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%.

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Through the later part of 2008 and into 2009 the number of bank failures began to rise significantly. This placed considerable strain on the DIF. As a result, on September 29, 2009 the FDIC adopted an Amended Restoration Plan to allow the DIF to return to a ratio of 1.15% within eight years. The FDIC also adopted higher annual risk-based assessment rates beginning in January of 2011. On November 12, 2009 the FDIC also adopted a final rule amending the assessment regulations to require insured depository institutions to prepay their quarterly risk-based assessments for the fourth quarter of 2009, and for all of 2010, 2011 and 2012, on December 30, 2009, except for those institutions where the FDIC grants an exemption. The prepaid assessment was collected December 30, 2009, and resulted in a prepayment by the Bank of $7,258,000.

Under the Dodd-Frank Act, the minimum designated reserve ratio of the DIF increased from 1.15 percent to 1.35 percent 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 is expected to take effect for the quarter beginning April 1, 2011.

The Bank's FDIC premiums were $2.3 million in 2010 compared to $1.7 million in 2009. The 2009 premium is net of special assessments in the amount of $798,000. Additional 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.

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 July 2010 and the Bank received an overall Satisfactory rating in complying with its CRA obligations.

The Sarbanes-Oxley Act of 2002
This legislation addresses certain accounting oversight and corporate governance matters, including but not limited to:

- the creation of a five-member oversight board that sets standards for accountants and has investigative and disciplinary powers;

-

the prohibition of accounting firms from providing various types of consulting services to public clients and requires accounting firms to rotate partners among public client assignments every five years;

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- increased penalties for financial crimes;
- expanded disclosure of corporate operations and internal controls and certification of financial statements;
- enhanced controls on, and reporting of, insider trading; and
- prohibition on lending to officers and directors of public companies, although the bank may continue to make these loans within the constraints of existing banking regulations.

As a public reporting company, the Company is subject to the requirements of this legislation and related rules and regulations issued by the Securities and Exchange Commission (the "SEC"). Compliance with the Act (the "Act") did not have a material impact upon its business. However, other non-interest expense items, including professional expenses and other costs related to compliance with the reporting requirements of the securities laws have significantly increased and can be expected to continue to increase.

Recent Governmental Actions in Response to the Financial Crises

Emergency Economic Stabilization Act
In response to the financial crisis affecting the banking system and financial markets, the Emergency Economic Stabilization Act ("EESA") was signed into law on October 3, 2008, which among other things: (1) temporarily increased FDIC insurance coverage from $100,000 to $250,000 through December 31, 2009 (subsequently extended through December 31, 2013); and (2) established the Troubled Asset Relief Program ("TARP"). As part of TARP, the United States Department of the Treasury ("Treasury") established the Capital Purchase Program ("CPP") to provide up to $700 billion of funding to eligible financial institutions through the purchase of capital stock and other financial instruments for the purpose of stabilizing and providing liquidity to the U.S. financial markets. In connection with EESA, there have been numerous actions by the FRB, Congress, and the Treasury, the FDIC, the SEC and others to further the economic and banking industry stabilization efforts under EESA. It remains unclear at this time what further legislative and regulatory measures will be implemented under EESA affecting the Company.

The Company decided not to participate in the TARP CPP.

Temporary Liquidity Guarantee Program
On October 14, 2008, the FDIC announced the establishment of the Temporary Liquidity Guarantee Program ("TLGP") to provide: (1) full deposit insurance on all non-interest bearing transaction account balances through December 31, 2009 (Transaction Account Guarantee Program); and (2) guarantees of certain newly issued senior unsecured debt issued by financial institutions and bank holding companies through June 30, 2012 (Debt Guarantee Program). The Bank participated in the Transaction Account Guarantee Program through June 30, 2010, but not the Debt Guarantee Program.

Financial Stability Plan
On February 10, 2009, Treasury announced the Financial Stability Plan ("FSP") which, among other things, established a new Capital Assistance Program ("CAP") through which eligible banking institutions will have access to Treasury capital as a bridge to private capital until market conditions normalize, and extended the Debt Guarantee Program of the TLGP to October 31, 2009, and the Transaction Account Guarantee Program of the TLGP to June 30, 2010. As a complement to CAP, a new Public-Private Investment Fund on an initial scale of up to $500 billion, which was later revised to be $30 billion, was announced to catalyze the removal of legacy assets from the balance sheets of financial institutions. This fund will combine public and private capital with government financing to help free up capital to support new lending. In addition, the existing Term Asset-Backed Securities Lending Facility ("TALF") would be expanded (up to $1 trillion) in order to reduce credit spreads and restart the securitized credit markets that in recent

years supported a substantial portion of lending to households, students, small businesses, and others. Furthermore, the FSP proposed a new framework of governance and oversight to help ensure that banks receiving funds are held responsible for appropriate use of those funds through stronger conditions on lending, dividends and executive compensation along with enhanced reporting to the public.

The Company was a participant in the Transaction Account Guarantee Program through June 30, 2010.

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American Recovery and Reinvestment Act of 2009

On February 17, 2009, the American Recovery and Reinvestment Act of 2009 (“ARRA”) was signed into law. ARRA is intended to provide tax breaks for individuals and businesses, direct aid to distressed states and individuals, and provide infrastructure spending. In addition, ARRA imposes new executive compensation and expenditure limits on all previous and future TARP CPP recipients and expands the class of employees to whom the limits and restrictions apply. ARRA also provides the opportunity for additional repayment flexibility for existing TARP CPP recipients. Among other things, ARRA prohibits the payment of bonuses, other incentive compensation and severance to certain highly paid employees (except in the form of restricted stock subject to specified limitations and conditions), and requires each TARP CPP recipient to comply with certain other executive compensation related requirements. These provisions modify the executive compensation provisions that were included in EESA, and in most instances apply retroactively for so long as any obligation arising from financial assistance provided to the recipient under TARP CPP remains outstanding.

In addition, ARRA directs the Treasury to review previously-paid bonuses, retention awards and other compensation paid to the senior executive officers and certain other highly-compensated employees of each TARP CPP recipient to determine whether any such payments were excessive, inconsistent with the purposes of ARRA or the TARP, or otherwise contrary to the public interest. If the Treasury determines that any such payments have been made by a TARP CPP recipient, the Treasury will seek to negotiate with the TARP CPP recipient and the subject employee for appropriate reimbursements to the U.S. government (not the TARP CPP recipient) with respect to any such compensation or bonuses. ARRA also permits the Treasury, subject to consultation with the appropriate federal banking agency, to allow a TARP CPP recipient to repay any assistance previously provided to such TARP CPP recipient under the TARP, without regard to whether the TARP CPP recipient has replaced such funds from any source, and without regard to any waiting period. Any TARP CPP recipient that repays its TARP assistance pursuant to this provision would no longer be subject to the executive compensation provisions under ARRA.

Since the Company elected not to participate in the TARP CPP, the preceding compensation limitations do not apply.

Homeowner Affordability and Stability Plan

On February 18, 2009, the Treasury announced the Homeowner Affordability and Stability Plan (“HASP”), which proposes to provide refinancing for certain homeowners, to support low mortgage rates by strengthening confidence in Fannie Mae and Freddie Mac, and to establish a Homeowner Stability Initiative to reach at-risk homeowners. Among other things, the Homeowner Stability Initiative would offer monetary incentive to mortgage servicers and mortgage holders for certain modifications of at-risk loans, and would establish an insurance fund designed to reduce foreclosures.

The Dodd-Frank Wall Street Reform and Consumer Protection Act

On July 21, 2010, President Obama signed into law the sweeping financial regulatory reform act, 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.

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 web site 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 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 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

Recession And Changes In Domestic And Foreign Financial Markets May Have A Material Negative Impact On Our Results Of Operations And Financial Condition - Economic indices have shown that since the fourth quarter of 2007, the United States economy has been in a recession and the Central Valley of California, the Company's primary market area, has been hit particularly hard. This has been reflected in: (1) 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 is experiencing a budget crisis that has yet to be solved); and (2)significant private sector business failures and job losses. In addition, over the past three years, the domestic and foreign financial markets, securities trading markets and economies generally have experienced significant turmoil including, without limitation, government takeovers of troubled institutions, government brokered mergers of such firms to avoid bankruptcy or failures, bankruptcies of securities trading firms and insurance companies, failures of financial institutions and securities brokerage firms, declines in real property values, and wide fluctuations in energy prices, all of which have contributed to reduced availability of credit for businesses and consumers, elevated foreclosures on residential and commercial properties, falling home prices, reduced liquidity and a lack of stability across the entire financial sector.

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These recent events and the corresponding uncertainty in financial markets may continue for the foreseeable future. The full extent of the repercussions to our nation's, our state's and our local economies in general and our business in particular; therefore, 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 with us in accordance with the terms thereof.

Recently Enacted Legislation And Other Measures Undertaken By The Treasury, The FRB And Other Governmental Agencies May Not Help Stabilize The U.S. Financial System Or Improve The Housing Market – Since 2008 the Federal Government has enacted many pieces of legislation designed to stabilize the economy and regulate the financial services industry. See "Item 1 Business – Supervision and Regulation – Recent Government Actions in Response to the Financial Crises."

The actual impact that any of this legislation and other related measures undertaken to alleviate the economic crises will have generally on the financial markets is still substantially unknown. The failure of such measures, or any future measures, to help stabilize the financial markets and a continuation or worsening of current financial market conditions could materially and adversely affect our business, financial condition, results of operations, access to credit or the trading price of our common stock.

Recent Levels Of Market Volatility Have Been Unprecedented - The capital and credit markets have been experiencing volatility and disruption for more than three years. At times the volatility and disruption reached unprecedented levels. In some cases, the markets have produced downward pressure on stock prices and credit availability for certain issuers without regard to those issuers' underlying financial strength. If recent levels of market disruption and volatility continue or worsen, there can be no assurance that we will not experience an adverse effect, which may be material, on our ability to access capital and on our business, financial condition and results of operations.

Nonperforming Assets Take Significant Time To Resolve And Adversely Affect Our Company's Results Of Operations And Financial Condition. Nonperforming assets adversely affect our net income in various ways. Until economic and market conditions improve, we expect to continue to incur additional losses relating to an increase in non-performing loans. We do not record interest income on non-accrual loans or other real estate owned, thereby adversely affecting our income and increasing our loan administration costs. When we take collateral in foreclosures and similar proceedings, we are required to mark the related loan to the then fair market value of the collateral, which may result in a loss. While we have tried to reduce our problem assets through workouts, restructurings and otherwise, decreases in the value of these assets, or the underlying collateral, or in these borrowers' performance or financial conditions, whether or not due to economic and market conditions beyond our control, could adversely affect our business, results of operations and financial condition. In addition, the resolution of nonperforming assets requires significant commitments of time from management, which can be detrimental to the performance of other responsibilities. There can be no assurance that we will not experience further increases in nonperforming loans in the future.

Our Allowance For Loan 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 and 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.

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Like all financial institutions, we maintain an allowance for loan losses to provide for loan 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 loan losses, which is a charge to our income statement. Our allowance for loan losses may not be adequate to cover actual loan losses, and future provisions for loan losses could materially and adversely affect our business, financial condition, results of operations and cash flows. The allowance for loan losses reflects our estimate of the probable losses in our loan portfolio at the relevant balance sheet date. Our allowance for loan 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 portfolio and economic factors. The determination of an appropriate level of loan 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.

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. 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 loan losses.

While we believe that our allowance for loan losses is adequate to cover current losses, we cannot assure you that we will not increase the allowance for loan 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 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, 2010, real estate served as the principal source of collateral with respect to approximately 64% of our loan outstandings and 19% of loans outstanding were secured by production agricultural properties. A continuing decline in current economic conditions 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, the credit profile of our borrowers, the rates received on loans and securities and rates paid on deposits and borrowings. The difference between the rates received on loans and securities and the rates paid on deposits and borrowings is known as interest rate margin. 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.”

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Sustained low levels of market interest rates could adversely affect our earnings. The Board of Governors of the Federal Reserve System 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 and investments, both of 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, 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 demand available in our market. The inability to make sufficient loans directly affects the interest income we earn. Lower loan 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: 2011 and Beyond.”

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;
- inability to maintain or increase non-interest income; and
- continuing ability to expand through de novo branching or otherwise.

Economic Conditions In Our Service Areas Could Adversely Affect Our Operations And/Or Cause Us To Sustain Losses - Our retail and commercial banking operations are concentrated primarily 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 this area and this area has experienced a significant deterioration in real estate values. A significant source of risk arises 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. This risk increases when the economy is weak as it is presently. We have adopted underwriting and credit monitoring procedures and credit policies, including the establishment and review of the allowance for loan losses, that management believes are appropriate to minimize this risk by assessing the likelihood of nonperformance, tracking loan 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: 2011 and Beyond.”

This Company’s service areas can be significantly impacted by the seasonal and cyclical 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). Additionally, although the Company’s loan portfolio is believed to be well diversified, at various times during 2010 approximately 38% 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, walnuts, 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.

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Our Ability To Access Markets For Funding And Acquire And Retain Customers Could Be Adversely Affected By The Deterioration Of Other Financial Institutions Or The Financial Service Industry's Reputation. Reputation risk is the risk to liquidity, earnings and capital arising from negative publicity regarding the financial services industry. The financial services industry continues to be featured in negative headlines about the global and national credit crisis and the resulting stabilization legislation enacted by the U.S. federal government. These reports can be damaging to the industry's image and potentially erode consumer confidence in insured financial institutions. Recent bank failures in California and throughout the United States have also had a negative impact. In addition, our ability to engage in routine funding and other transactions could be adversely affected by the actions and commercial soundness of other financial institutions. Financial services institutions are interrelated as a result of trading, clearing, counterparty or other relationships. As a result, defaults by, or even rumors or questions about, one or more financial services institutions, or the financial services industry generally, have led to market-wide liquidity problems, losses of depositor, creditor and counterparty confidence and could lead to losses or defaults by us or by other institutions.

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. We compete for loans principally through the interest rates and loan 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 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.

Deposit Insurance Assessments Have Increased Substantially and May Continue to Increase, Which Will Adversely Affect Profits - FDIC deposit insurance expense for the years 2009 and 2010 averaged $2.4 million. This represents a $1.8 million increase over 2008. Additionally, the FDIC has recently changed its methodology for calculating deposit premiums, See "Item 1. Business – Supervision and Regulation – Deposit Insurance." Deposit insurance assessments may continue to increase in future years due to recent strains on the FDIC deposit insurance fund resulting from the cost of recent bank failures and an increase in the number of banks likely to fail over the next few years.

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.

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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 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.

Severe weather, 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, impair the value of collateral securing loans, 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 severe weather or 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 Our Subsidiary Bank To Meet Our Cash Obligations - As a holding company, dividends from our subsidiary bank provide a substantial portion of our cash flow used to service the interest payments on our Trust Preferred Securities 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.

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. 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 through the Federal Reserve System, significantly affects economic conditions for us.

New Legislative And Regulatory Proposals May Affect Our Operations And Growth - 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 EESA, ARRA, HASP and the Dodd-Frank Act, might have on us or our subsidiaries 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. See “Item 1 Business – Supervision and Regulation – Recent Government Actions in Response to the Financial Crises.”

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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 may be reported on the OTC Bulletin Board under the symbol "FMCB.OB." 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.

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-two branch locations in the Company's service area. Of the twenty-two branches, sixteen are owned and six are leased. The expiration of these leases occurs between the years 2011 and 2016. 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.

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Item 4. Reserved

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 may be reported on the OTC Bulletin Board under the symbol "FMCB.OB." Additionally, management is aware that there are private transactions in the Company's common stock.

The following table summarizes the actual high, low, and close sale prices for the Company's common stock since the first quarter of 2009. 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)
2010	Fourth quarter	$ 425	$ 400	$ 415	$ 6.00
	Third quarter	425	400	415	-
	Second quarter	450	355	380	5.35
	First quarter	385	355	380	-

	Calendar Quarter	High	Low	Close	Cash Dividends Declared (Per Share)
2009	Fourth quarter	$ 425	$ 325	$ 380	$ 5.90
	Third quarter	434	375	400	-
	Second quarter	475	325	395	5.10
	First quarter	475	310	390	-

As of January 31, 2011, there were approximately 1,478 stockholders of record of the Company's common stock.

The Company has paid cash dividends for the past 76 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 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 stock repurchase program. This program was extended and expanded in both 2004 and 2006. Most recently, on November 12, 2008, the Board of Directors approved increasing the funds available for the Company's Common Stock Repurchase Program. The Board's resolution authorized up to $20 million in repurchases over the four-year period ending October 31, 2012.

Repurchases under the program will continue to be made 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.

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The following table indicates the number of shares repurchased by the Company during the fourth quarter of 2010.

Period	Number of Shares	Average Price per Share	Number of Shares Purchased as Part of a Publicly Announced Plan or Program	Approximate Dollar Value of Shares that May Yet Be Purchased Under the Plan or Program
October 2010	1,520	$400	1,520	$ 16,015,500
November 2010	-	-	-	16,015,500
December 2010	-	-	-	16,015,500
Total	1,520	$400	1,520	$ 16,015,500

All of the above shares were repurchased in private transactions.

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 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 the Company'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 the Company's Board of Directors at a price of $0.001 per Right. The Rights Plan will expire on August 5, 2018.

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Performance Graphs

The following graph compares the Company's cumulative total stockholder return on common stock from December 31, 2005 to December 31, 2010 to that of: (i) the Morningstar Banks Index - Regional (US) Industry Group; (ii) the Hemscott Group Index of banks and bank holding companies throughout the United States; and (iii) the cumulative total return of the American Stock Exchange market index. The Company has used the Hemscott Index as its comparative industry index in prior years. As a result of Morningstar's acquisition of the Hemscott businesses, the Company expects to use the Morningstar Index, a comparable industry index, in future years. The graph assumes an initial investment of $100 on December 31, 2005 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 Morningstar, Inc.

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

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Item 6. Selected Financial Data

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

Summary of Income:	2010	2009	2008	2007	2006
Total Interest Income	$84,461	$91,314	$93,208	$95,775	$88,396
Total Interest Expense	9,685	16,331	24,784	32,225	24,621
Net Interest Income	74,776	74,983	68,424	63,550	63,775
Provision for Loan Losses	14,735	15,420	7,998	1,495	275
Net Interest Income After Provision for Loan Losses	60,041	59,563	60,426	62,055	63,500
Total Non-Interest Income	17,185	18,194	16,064	15,455	12,063
Total Non-Interest Expense	43,939	46,429	40,103	41,945	43,121
Income Before Income Taxes	33,287	31,328	36,387	35,565	32,442
Provision for Income Taxes	12,169	11,315	13,597	12,870	11,813
Net Income	$21,118	$20,013	$22,790	$22,695	$20,629
Balance Sheet Data:					
Total Assets	$1,841,491	$1,781,014	$1,684,437	$1,519,172	$1,411,233
Loans	1,176,002	1,212,718	1,177,364	1,140,969	1,046,912
Allowance for Loan Losses	32,261	29,813	20,034	18,483	18,099
Investment Securities	499,793	435,166	363,729	247,637	243,867
Deposits	1,566,503	1,498,124	1,432,702	1,310,790	1,198,528
Federal Home Loan Bank Advances	591	20,149	703	28,954	47,532
Shareholders' Equity	173,241	164,727	156,545	143,418	132,340
Selected Ratios:					
Return on Average Assets	1.19 %	1.15 %	1.44 %	1.56 %	1.51 %
Return on Average Equity	12.25 %	12.33 %	15.23 %	16.26 %	16.16 %
Dividend Payout Ratio	41.93 %	42.95 %	36.99 %	34.51 %	33.77 %
Average Loans to Average Deposits	79.03 %	80.12 %	84.16 %	86.86 %	90.24 %
Average Equity to Average Assets	9.74 %	9.34 %	9.46 %	9.60 %	9.38 %
Period-end Shareholders' Equity to Total Assets	9.41 %	9.25 %	9.29 %	9.44 %	9.38 %
Per Share Data:					
Net Income (1)	$27.05	$25.57	$28.69	$28.05	$25.25
Cash Dividends Per Share	$11.35	$11.00	$10.65	$9.70	$8.55

(1) Based on the weighted average number of shares outstanding of 780,619, 782,754, 794,239, 809,057, and 817,044 for the years ended December 31, 2010, 2009, 2008, 2007, and 2006, respectively.

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

Overview

The Company's primary service area encompasses 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: 2006 through 2010
The years 2006 through 2010 were comprised of two very distinct economic periods. From 2006 through the first half of 2007 the economy 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 a prolonged economic recession began that, at least in the Central Valley of California, continues even today. This area has been one of the hardest hit areas in the country during this recession. Housing prices in many areas are down as much as 60% and the economic stress has spread from residential real estate to other industry segments such as autos and commercial real estate. Unemployment levels are above 15% in many areas.

Despite what can only be described as a roller coaster ride, in management's opinion, the Company's operating performance was exceptionally strong throughout this timeframe.

(in thousands, except per share data)

Financial Performance Indicator	2010	2009	2008	2007	2006
Net Income	$ 21,118	$ 20,013	$ 22,790	$ 22,695	$ 20,629
Total Assets	$ 1,841,491	$ 1,781,014	$ 1,684,437	$ 1,519,172	$ 1,411,233
Total Loans	$ 1,176,002	$ 1,212,718	$ 1,177,364	$ 1,140,969	$ 1,046,912
Total Deposits	$ 1,566,503	$ 1,498,124	$ 1,432,702	$ 1,310,790	$ 1,198,528
Total Shareholders' Equity	$ 173,241	$ 164,727	$ 156,545	$ 143,418	$ 132,340
Total Consolidated Risk-Based Capital Ratio	13.82 %	12.48 %	12.59 %	12.21 %	12.17 %
Non-Performing Loans as a % of Total Loans	0.45 %	0.76 %	0.45 %	0.01 %	0.00 %
Net Charge-Offs to Average Loans	1.04 %	0.48 %	0.57 %	0.10 %	0.00 %

Loan Loss Allowance as a % of Total Loans	2.74 %	2.45 %	1.70 %	1.62 %	1.72 %
Return on Average Assets	1.19 %	1.15 %	1.44 %	1.56 %	1.51 %
Return on Average Equity	12.25 %	12.33 %	15.23 %	16.26 %	16.16 %
Earnings Per Share	$ 27.05	$ 25.57	$ 28.69	$ 28.05	$ 25.25
Cash Dividends Per Share	$ 11.35	$ 11.00	$ 10.65	$ 9.70	$ 8.55
Cash Dividends Declared	$ 8,855	$ 8,596	$ 8,430	$ 7,831	$ 6,966
# Shares Repurchased During Year	1,520	6,016	13,152	11,821	11,718
Average Share Price of Repurchased Shares	$ 400	$ 387	$ 449	$ 460	$ 507
High Stock Price – Fourth Quarter	$ 425	$ 425	$ 450	$ 460	$ 557
Low Stock Price – Fourth Quarter	$ 400	$ 325	$ 385	$ 381	$ 505
Closing Stock Price – Fourth Quarter	$ 415	$ 380	$ 420	$ 460	$ 515

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Over the five-year period:

- Net income totaled $107.2 million and never dropped below $20 million in any single year.
- Return on Average Assets averaged 1.37%, and never dropped below 1.15% in any single year.
- Total assets increased 36.1% to $1.8 billion.
- Total loans increased 20.8% to $1.2 billion.
- Total deposits increased 41.9% to $1.6 billion.

For many banks the three years 2008 through 2010 were a particularly difficult period when major credit quality problems surfaced that resulted in significant declines in profits or even losses. 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 this three-year period ending December 31, 2010:

- In 2010 the Company earned $21.1 million for a return on average assets of 1.19%, and our return on average assets averaged 1.26% over the three-year period. Importantly, these strong results were generated at the same time the Company strengthened its loan loss allowance by $13.8 million, to $32.3 million or 2.74% of total loans.

- In 2010 the Company increased its cash dividend per share by 3.2% over 2009 levels, and our strong financial performance allowed us to increase dividends every year during this three-year period, even as many banks eliminated or significantly reduced their dividends.

- The Company's risk based capital ratio was ––13.82% at December 31, 2010, and the Company achieved the highest regulatory classification of "well capitalized" in each of the three years. See "Financial Condition – Capital."

- The Company's asset quality remains very strong compared to peer banks at the present time, when measured by net charge-offs of 0.70% of average loans during this three-year period and non-performing loans totaling 0.45% of total loans at December 31, 2010. See "Results of Operations – Provision and Allowance for Loan Losses" and "Financial Condition – Classified Loans and Non-Performing Assets."

As a result of this strong earnings performance, capital position, and asset quality, stockholders have benefited well in excess of overall bank and bank holding company stock market returns over the past five years:

- Cash dividends per share have increased 47.8% since 2005, and totaled $51.25 per share over the five-year period.

- The total return on the Company's stock over the past five years compares very favorably to overall stock market returns of other banks and bank holding companies. See "Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Security - Performance Graphs."

- The Company did not dilute existing common stockholders by participating in the Federal Government's 2008 TARP Capital Purchase Program. See "Item 1. Business – Supervision and Regulation - Recent Governmental Actions in Response to the Financial Crises."

Looking Forward: 2011 and Beyond

In management's opinion, the following key issues will influence the financial results of the Company in 2011 and future years:

- The Company's earnings are sensitive to changes in market interest rates. See "Item 7A. Quantitative and Qualitative Disclosures About Market Risk - Interest Rate Risk."

  - During the third quarter of 2007, the FRB began decreasing short-term market rates, resulting in pressure on the Company's net interest margin, which declined from 4.89% in the second quarter of 2007 to 4.54% for the fourth quarter of 2010. Market rates remain low, placing continued pressure on the net interest margin.
  - In addition to changes in market interest rates, the Company's net interest margin has come under pressure from: (1) aggressive competitor pricing strategies for both loans and deposits to which the Company needs to respond in order to retain key customers; and (2) changes in deposit mix as customers move funds from low or non-interest bearing transaction and savings accounts to higher yielding time deposits.

- The Company's results can be significantly influenced by changes in the credit quality of its borrowers. Non-performing loans totaled $5.3 million or 0.45% of total loans at December 31, 2010. Management believes based on information currently available that these levels are adequately covered by the Company's $32.3 million allowance for loan losses as of December 31, 2010. See "Results of Operations - Provision and Allowance for Loan Losses" and "Financial Condition – Classified Loans and Non-Performing Assets." The Company's provision for loan losses was $14.7 million in 2010, a slight decrease from $15.4 million in 2009. Given the continued recessing economy in the Central Valley of California, many of the Company's borrowers continue to feel the impact of the recession. See "Item 1A. Risk Factors."

- FDIC deposit insurance assessments have increased substantially and may continue to increase, which will adversely affect profits. FDIC deposit insurance expense for the years ended December 31, 2009 and 2010 averaged $2.4 million. This represents a $1.8 million increase over 2008. See "Results of Operations – Non-Interest Expense." Additionally, in December 2009 the FDIC required all banks to prepay three years of estimated insurance premiums, an amount that totaled $7.26 million for the Bank. Deposit insurance assessments may continue to increase in future years due to recent strains on the FDIC deposit insurance fund resulting from the cost of recent bank failures.

- Congress and the Obama Administration have implemented, or are proposing, 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 services charges, particularly fees associated with the Company's Overdraft Privilege Service. See "Results of Operations – Non-Interest Income."

In addition to the preceding issues, beginning in 2003 management initiated a branch expansion, relocation and renovation program. Between 2003 and 2009, six new branches were opened and several other branches underwent major renovations or relocations. In management's opinion, these moves are integral to the long-term strategic positioning of the Company. Although no other branch expansions are currently in process, the Company is always active in identifying areas of our branch system that are candidates for expansion.

Capital expenditures associated with this multi-year branch program were approximately $15 million. In addition, the increased staffing and other operating expenses associated with these new branches places pressure on the Company's earnings until these branches reach break-even.

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, 2010, and the material changes in financial condition, operating income, and expense of the Company and its subsidiaries as shown in the accompanying financial statements.

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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 2010, 2009, and 2008. 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 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 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.”

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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, 2010		
Assets	Balance	Interest	Rate
Federal Funds Sold and Securities Purchased Under Agreements to Resell	$ 37,909	$ 91	0.24 %
Investment Securities Available-for-Sale			
U.S. Agencies	179,442	2,438	1.36 %
Municipals - Non-Taxable	6,801	520	7.64 %
Mortgage Backed Securities	153,269	6,345	4.14 %
Other	4,120	30	0.73 %
Total Investment Securities Available-for-Sale	343,632	9,333	2.72 %
Investment Securities Held-to-Maturity			
Municipals - Non-Taxable	63,602	3,682	5.79 %
Mortgage Backed Securities	2,893	111	3.84 %
Other	2,022	46	2.27 %
Total Investment Securities Held-to-Maturity	68,517	3,839	5.60 %
Loans			
Real Estate	716,558	45,438	6.34 %
Home Equity	63,025	3,711	5.89 %
Agricultural	214,614	12,827	5.98 %
Commercial	175,991	10,184	5.79 %
Consumer	8,549	469	5.49 %
Other	977	14	1.43 %
Total Loans	1,179,714	72,643	6.16 %
Total Earning Assets	1,629,772	$ 85,906	5.27 %
Unrealized Gain on Securities Available-for-Sale	7,572		
Allowance for Loan Losses	(32,133)		
Cash and Due From Banks	29,950		
All Other Assets	133,582		
Total Assets	$ 1,768,743		
Liabilities & Shareholders' Equity			
Interest Bearing Deposits			
Interest Bearing DDA	$ 174,741	$ 222	0.13 %
Savings	441,289	186	0.04 %
Time Deposits	575,516	6,760	1.17 %
Total Interest Bearing Deposits	1,191,546	7,168	0.60 %
Securities Sold Under Agreement to Repurchase	60,000	2,148	3.58 %
Other Borrowed Funds	1,223	36	2.94 %
Subordinated Debt	10,310	333	3.23 %
Total Interest Bearing Liabilities	1,263,079	$ 9,685	0.77 %
Interest Rate Spread			4.50 %

Demand Deposits	301,250		
All Other Liabilities	32,082		
Total Liabilities	1,596,411		
Shareholders' Equity	172,332		
Total Liabilities & Shareholders' Equity	$ 1,768,743		
Impact of Non-Interest Bearing Deposits and Other Liabilities			0.17 %
Net Interest Income and Margin on Total Earning Assets		76,221	4.68 %
Tax Equivalent Adjustment		(1,445)	
Net Interest Income		$ 74,776	4.59 %

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 $1.1 million for the year ended December 31, 2010. 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.

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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, 2009		
Assets	Balance	Interest	Rate
Federal Funds Sold and Securities Purchased Under Agreements to Resell	$ 36,767	$ 96	0.26 %
Investment Securities Available-for-Sale			
U.S. Agencies	59,760	1,036	1.73 %
Municipals - Non-Taxable	9,194	704	7.66 %
Mortgage Backed Securities	243,280	12,100	4.97 %
Other	8,312	42	0.51 %
Total Investment Securities Available-for-Sale	320,546	13,882	4.33 %
Investment Securities Held-to-Maturity			
Municipals - Non-Taxable	64,121	3,717	5.80 %
Mortgage Backed Securities	4,365	167	3.83 %
Other	1,991	51	2.56 %
Total Investment Securities Held-to-Maturity	70,477	3,935	5.58 %
Loans			
Real Estate	697,377	45,555	6.53 %
Home Equity	65,802	3,984	6.05 %
Agricultural	208,678	12,684	6.08 %
Commercial	200,560	11,902	5.93 %
Consumer	10,666	762	7.14 %
Other	1,077	14	1.30 %
Total Loans	1,184,160	74,901	6.33 %
Total Earning Assets	1,611,950	$ 92,814	5.76 %
Unrealized Gain on Securities Available-for-Sale	9,467		
Allowance for Loan Losses	(23,396)		
Cash and Due From Banks	31,373		
All Other Assets	109,461		
Total Assets	$ 1,738,855		
Liabilities & Shareholders' Equity			
Interest Bearing Deposits			
Interest Bearing DDA	$ 155,000	$ 308	0.20 %
Savings	392,770	2,569	0.65 %
Time Deposits	652,787	10,869	1.67 %
Total Interest Bearing Deposits	1,200,557	13,746	1.14 %
Securities Sold Under Agreement to Repurchase	60,000	2,148	3.58 %
Other Borrowed Funds	1,817	40	2.20 %
Subordinated Debt	10,310	397	3.85 %
Total Interest Bearing Liabilities	1,272,684	$ 16,331	1.28 %
Interest Rate Spread			4.47 %

Demand Deposits		277,398				
All Other Liabilities		26,414				
Total Liabilities		1,576,496				
Shareholders' Equity		162,359				
Total Liabilities & Shareholders' Equity	$	1,738,855				
Impact of Non-Interest Bearing Deposits and Other Liabilities					0.27	%
Net Interest Income and Margin on Total Earning Assets				76,483	4.74	%
Tax Equivalent Adjustment				(1,500)		
Net Interest Income			$	74,983	4.65	%

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 $1.5 million for the year ended December 31, 2009. 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.

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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, 2008		
Assets	Balance	Interest	Rate
Federal Funds Sold and Securities Purchased Under Agreements to Resell	$ 16,642	$ 424	2.55 %
Investment Securities Available-for-Sale			
U.S. Agencies	601	23	3.83 %
Municipals - Non-Taxable	9,277	703	7.57 %
Mortgage Backed Securities	187,686	10,078	5.37 %
Other	3,508	266	7.58 %
Total Investment Securities Available-for-Sale	201,072	11,070	5.51 %
Investment Securities Held-to-Maturity			
U.S. Agencies	27,567	1,154	4.19 %
Municipals - Non-Taxable	66,538	3,879	5.83 %
Mortgage Backed Securities	5,926	229	3.86 %
Other	1,997	52	2.60 %
Total Investment Securities Held-to-Maturity	102,028	5,314	5.21 %
Loans			
Real Estate	663,336	45,781	6.90 %
Home Equity	65,356	4,343	6.65 %
Agricultural	183,644	12,988	7.07 %
Commercial	202,001	13,574	6.72 %
Consumer	12,328	958	7.77 %
Credit Card	2,624	265	10.10 %
Other	1,184	15	1.27 %
Total Loans	1,130,473	77,924	6.89 %
Total Earning Assets	1,450,215	$ 94,732	6.53 %
Unrealized Gain (Loss) on Securities Available-for-Sale	1,565		
Allowance for Loan Losses	(18,741)		
Cash and Due From Banks	43,796		
All Other Assets	104,646		
Total Assets	$ 1,581,481		
Liabilities & Shareholders' Equity			
Interest Bearing Deposits			
Interest Bearing DDA	$ 132,686	$ 125	0.09 %
Savings	331,879	3,647	1.10 %
Time Deposits	606,738	18,602	3.07 %
Total Interest Bearing Deposits	1,071,303	22,374	2.09 %
Securities Sold Under Agreement to Repurchase	43,607	1,528	3.50 %
Other Borrowed Funds	8,329	245	2.94 %
Subordinated Debt	10,310	637	6.18 %

Total Interest Bearing Liabilities	1,133,549	$ 24,784	2.19	%
Interest Rate Spread			4.35	%
Demand Deposits	271,994			
All Other Liabilities	26,347			
Total Liabilities	1,431,890			
Shareholders' Equity	149,591			
Total Liabilities & Shareholders' Equity	$ 1,581,481			
Impact of Non-Interest Bearing Deposits and Other Liabilities			0.48	%
Net Interest Income and Margin on Total Earning Assets		69,948	4.82	%
Tax Equivalent Adjustment		(1,524)		
Net Interest Income		$ 68,424	4.72	%

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 $2.2 million for the year ended December 31, 2008. 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.

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Farmers & Merchants Bancorp
Volume and Rate Analysis of Net Interest Revenue
(Interest and Rates on a Taxable Equivalent Basis)
(in thousands)

	2010 versus 2009 Amount of Increase (Decrease) Due to Change in:		
Interest Earning Assets	Volume	Rate	Net Chg.
Federal Funds Sold	$3	$(8)	$(5)
Investment Securities Available-for-Sale			
U.S. Agencies	1,670	(268)	1,402
Municipals - Non-Taxable	(183)	(1)	(184)
Mortgage-backed Securities	(3,960)	(1,795)	(5,755)
Other	(27)	15	(12)
Total Investment Securities Available-for-Sale	(2,500)	(2,049)	(4,549)
Investment Securities Held-to-Maturity			
Municipals - Non-Taxable	(30)	(5)	(35)
Mortgage-backed Securities	(56)	-	(56)
Other	1	(6)	(5)
Total Investment Securities Held-to-Maturity	(85)	(11)	(96)
Loans:			
Real Estate	1,235	(1,352)	(117)
Home Equity	(166)	(107)	(273)
Agricultural	357	(214)	143
Commercial	(1,428)	(290)	(1,718)
Consumer	(90)	(203)	(293)
Other	(18)	18	-
Total Loans	(110)	(2,148)	(2,258)
Total Earning Assets	(2,692)	(4,216)	(6,908)
Interest Bearing Liabilities			
Interest Bearing Deposits:			
Interest Bearing DDA	35	(121)	(86)
Savings	282	(2,665)	(2,383)
Time Deposits	(1,178)	(2,931)	(4,109)
Total Interest Bearing Deposits	(861)	(5,717)	(6,578)
Securities Sold Under Agreement to Repurchase	-	-	-
Other Borrowed Funds	(15)	11	(4)
Subordinated Debt	-	(64)	(64)
Total Interest Bearing Liabilities	(876)	(5,770)	(6,646)
Total Change	$(1,816)	$1,554	$(262)

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.

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Farmers & Merchants Bancorp
Volume and Rate Analysis of Net Interest Revenue
(Interest and Rates on a Taxable Equivalent Basis)
(in thousands)

	2009 versus 2008 Amount of Increase (Decrease) Due to Change in:		
Interest Earning Assets	Volume	Rate	Net Chg.
Federal Funds Sold	$249	$(577)	$(328)
Investment Securities Available-for-Sale			
U.S. Agencies	1,032	(19)	1,013
Municipals - Non-Taxable	(6)	7	1
Mortgage-backed Securities	2,809	(788)	2,021
Other	162	(386)	(224)
Total Investment Securities Available-for-Sale	3,997	(1,186)	2,811
Investment Securities Held-to-Maturity			
U.S. Agencies	(577)	(577)	(1,154)
Municipals - Non-Taxable	(141)	(21)	(162)
Mortgage-backed Securities	(59)	(3)	(62)
Other	-	(1)	(1)
Total Investment Securities Held-to-Maturity	(777)	(602)	(1,379)
Loans:			
Real Estate	2,287	(2,512)	(225)
Home Equity	30	(389)	(359)
Agricultural	1,647	(1,951)	(304)
Commercial	(97)	(1,575)	(1,672)
Consumer	(122)	(74)	(196)
Credit Card	(132)	(133)	(265)
Other	(1)	-	(1.00)
Total Loans	3,612	(6,634)	(3,022)
Total Earning Assets	7,081	(8,999)	(1,918)
Interest Bearing Liabilities			
Interest Bearing Deposits:			
Interest Bearing DDA	24	159	183
Savings	585	(1,663)	(1,078)
Time Deposits	1,320	(9,053)	(7,733)
Total Interest Bearing Deposits	1,929	(10,557)	(8,628)
Securities Sold Under Agreement to Repurchase	586	33	619
Other Borrowed Funds	(156)	(49)	(205)
Subordinated Debt	-	(239)	(239)
Total Interest Bearing Liabilities	2,359	(10,812)	(8,453)
Total Change	$4,722	$1,813	$6,535

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.

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2010 Compared to 2009

Net interest income decreased 0.3% to $74.8 million during 2010. On a fully tax equivalent basis, net interest income decreased 0.3% and totaled $76.2 million during 2010 compared to $76.5 million for 2009. As more fully discussed below, the decrease in net interest income was primarily due to 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 2010, the Company's net interest margin was 4.68% compared to 4.74% in 2009. This decrease in net interest margin was due primarily to: (1) a decline in loans as a percentage of total earning assets; (2) a drop in mortgage-backed securities as a percentage of total investment securities; and (3) a decline in the average yield on U.S. Government Agency securities as maturing amounts were reinvested at rates below those rates available 12-24 months ago.

Loans, generally the Company's highest earning assets, decreased $36.7 million as of December 31, 2010, compared to December 31, 2009. See "Financial Condition – Loans" for further discussion of this decrease. On an average balance basis, loans decreased by $4.4 million for the year ended December 31, 2010. Loans decreased from 73.5% of average earning assets during 2009 to 72.4% in 2010. As a result of the lagging impact of decreases in market interest rates from mid-September 2007 through December 2008 the year-to-date yield on the loan portfolio declined to 6.16% for the year ended December 31, 2010, compared to 6.33% for the year ended December 31, 2009. The decrease in loan balances combined with the lower yield resulted in interest revenue from loans decreasing 3.0% to $72.6 million for 2010. The Company has been experiencing aggressive competitor pricing for loans 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 yields and net interest margin.

The investment portfolio is the other main component of the Company's earning assets. The Company invests primarily in mortgage-backed securities issued by government-sponsored entities, U.S. Government Agencies, and high-grade bank-qualified municipals. Since the risk factor for these types of investments is significantly lower than that of loans, the yield earned on investments is generally less than that of loans. Importantly, the Company never invested in the preferred stock or subordinated debt of Fannie Mae "FNMA" or Freddie Mac "FHLMC," securities that caused many banks to incur losses in recent years.

Average investment securities increased $21.1 million in 2010 compared to the average balance during 2009. As of year-end 2010 investment securities were $64.6 million greater than at year-end 2009. In order to reduce the Company's exposure to rising market interest rates, during 2010 the mix of investment securities was shifted away from longer-term higher yielding mortgage-backed securities to shorter-term lower yielding U.S. Government Agency securities. See "Financial Condition – Investment Securities" for a discussion of the Company's investment strategy in 2010. As a result, tax equivalent interest income on securities decreased $4.6 million to $13.2 million for the year ended December 31, 2010, compared to $17.8 million for the year ended December 31, 2009. The average yield, on a tax equivalent basis, in the investment portfolio was 3.2% in 2010 compared to 4.5% in 2009. 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.

Overnight investments in Federal Funds Sold are an additional earning asset available to the Company. Historically, in order to earn interest on excess cash balances banks had to "sell" these balances (called "Federal Funds Sold") on an overnight basis to other banks. However, in late 2008 the FRB began paying interest on the deposits that banks maintained in their FRB accounts (which are also classified as Federal Funds Sold on the Company's balances sheet) providing an essentially risk-free alternative for earning interest on overnight cash balances. These balances earn interest at the Fed Funds rate which has been 0.25% since December, 2008. Average Federal Funds Sold (which includes interest-earning balances at the FRB) for the year ended December 31, 2010 was $37.9 million, an increase of $1.1 million from the average balance for the year ended December 31, 2009.

Average interest-bearing liabilities decreased $9.6 million or 0.7% during the twelve months ended December 31, 2010. Of that decrease: (1) interest-bearing deposits decreased $9.0 million; (2) FHLB Advances decreased $594,000; and (3) securities sold under agreement to repurchase and subordinated debt remained unchanged.

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The $9.0 million decrease in average interest-bearing deposits was primarily in time deposits, which declined $77.3 million since 2009, as lower cost interest bearing DDA and Savings increased by $68.3 million. See “Financial Condition – Deposits” for a discussion of trends in the Company’s deposit base. Total interest expense on deposits was $7.2 million for 2010 as compared to $13.7 million for 2009. The average rate paid on interest-bearing deposits was 0.60% in 2010 and 1.14% in 2009. In September 2007 the FRB began lowering short-term market interest rates and has continued to keep these rates very low. 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. The Company anticipates that this decline in deposit rates, if any, will be much more modest in 2011. See “Overview – Looking Forward: 2011 and Beyond” for a discussion of factors impacting the Company’s future deposit rates and their impact on net interest margin.

2009 Compared to 2008

Net interest income increased 9.6% to $74.9 million during 2009. On a fully tax equivalent basis, net interest income increased 9.3% and totaled $76.4 million during 2009 compared to $69.9 million for 2008. As more fully discussed below, the increase in net interest income was primarily due to an 11.2% increase in average earning assets.

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 2009, the Company’s net interest margin was 4.74% compared to 4.82% in 2008.

Loans, generally the Company’s highest earning assets, increased $35.3 million as of December 31, 2009, compared to December 31, 2008. On an average balance basis, loans increased by $53.7 million for the year ended December 31, 2009. Loans decreased from 77.9% of average earning assets during 2008 to 73.5% in 2009. As a result of decreases in market interest rates from mid-September 2007 through December 2008 the year-to-date yield on the loan portfolio declined to 6.33% for the year ended December 31, 2009, compared to 6.89% for the year ended December 31, 2008. Even with the increase in loan balances, the decrease in yield resulted in interest revenue from loans decreasing 3.9% to $53.7 million for 2009.

The investment portfolio is the other main component of the Company’s earning assets. The Company invests primarily in mortgage-backed securities issued by government-sponsored entities, U.S. Government Agencies, and high-grade municipals. Since the risk factor for these types of investments is significantly lower than that of loans, the yield earned on investments is generally less than that of loans. Importantly, the Company never invested in the preferred stock or subordinated debt of Fannie Mae “FNMA” or Freddie Mac “FHLMC,” securities that caused many banks to incur losses in recent years.

Average investment securities increased $87.9 million in 2009 compared to the average balance during 2008. As of year-end 2009 investment securities were $71.4 million greater than at year-end 2008. Interest income on securities increased $1.4 million to $17.8 million for the year ended December 31, 2009, compared to $16.4 million for the year ended December 31, 2008. The average yield, on a tax equivalent basis, in the investment portfolio was 4.5% in 2009 compared to 5.4% in 2008. 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 sources of funds increased $139.1 million or 12.3% during 2009. Of that increase, securities sold under agreement to repurchase, a new borrowing added during the first quarter of 2008 to manage the Company’s interest rate risk, increased $16.4 million, interest-bearing deposits increased $129.2 million, and other borrowed funds decreased $6.5 million.

During 2009, the Company was able to grow average interest bearing deposits by $129.2 million. Total interest expense on deposits was $13.7 million in 2009 as compared to $22.4 million in 2008. The average rate paid on interest-bearing deposits was 1.1% in 2009 and 2.1% in 2008. Since September 2007 the FRB has been lowering market rates. The Company has begun to feel this beneficial impact as the average rate paid on interest-bearing liabilities declined to 1.3% in December 2009.

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Provision and Allowance for Loan 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 and the monitoring of the existing portfolio. The Company manages and controls credit risk through comprehensive underwriting and approval standards, dollar limits on loans to one borrower, and by restricting loans 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 portfolio and regularly conducts credit reviews of individual loans. Loans that are performing but have shown some signs of weakness are subjected to more stringent reporting and oversight.

Allowance for Loan Losses

The allowance for loan losses is an estimate of credit losses inherent in the Company's loan portfolio as of the balance-sheet date. The allowance is established through a provision for loan 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 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 two primary components, specific reserves related to impaired loans and general reserves for inherent losses related to loans that are not impaired.

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

A restructuring of a loan constitutes a troubled debt restructuring (TDR) if the Company for economic or legal reasons related to the debtor's financial difficulties grants a concession to the debtor that it would not otherwise consider. Restructured loans typically present an elevated level of credit risk as the borrowers are not able to perform according to the original contractual terms. Loans that are reported as TDRs are considered impaired and measured for impairment as described above.

Generally, the Company will not restructure loans for customers unless: (i) the existing loan is brought current as to principal and interest payments; and (ii) the restructured loan can be underwritten to reasonable underwriting standards. If these standards are not met other actions will be pursued (e.g., foreclosure) to collect outstanding loan amounts. After restructure a determination is made whether the loan will be kept on accrual status based upon the underwriting of the restructured credit.

The determination of the general reserve for loans that are not impaired 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 to 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 portfolio, and probable losses inherent in the portfolio taken as a whole.

The Company maintains a separate allowance for each portfolio segment (loan 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, and (8) consumer. See "Financial Condition – Loans" for examples of loans made by the Company. The allowance for loan losses attributable to each portfolio segment, which includes both impaired loans and loans that are not impaired, is combined to determine the Company's overall allowance, which is included on the consolidated balance sheet.

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The Company assigns a risk rating to all loans except pools of homogeneous loans (i.e., residential 1st mortgages, home equity and consumer) and periodically performs detailed reviews of all such loans over a certain threshold to identify credit risks and to assess the overall collectability of the portfolio. During these internal reviews, 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. These credit quality indicators are used to assign a risk rating to each individual loan. 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 is a strong credit with no existing or known potential weaknesses deserving of management's close attention.

Special Mention – A special mention loan 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 in the Company's credit position at some future date. Special Mention loans are not adversely classified and do not expose the Company to sufficient risk to warrant adverse classification.

Substandard – A substandard loan 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 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 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, on the basis of currently known facts, conditions and values, highly questionable or improbable.

Loss – Loans classified as loss are considered uncollectible. Once a loan 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 loan 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 generally possess a higher inherent risk of loss than other real estate portfolio segments, except land and construction loans. 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.

Agricultural Real Estate and Agricultural – Loans secured by crop production, livestock and related real estate are vulnerable to two risk factors that are largely outside the control of Company and borrowers: commodity prices and weather conditions.

Real Estate Construction – Real Estate Construction loans, including land loans, generally possess a higher inherent risk of loss than other real estate portfolio segments. 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 – Commercial loans generally possess a lower inherent risk of loss than real estate portfolio segments because these loans are generally underwritten to existing cash flows of operating businesses. 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.

Residential 1st Mortgages and Home Equity Lines and Loans – 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. These loans generally possess a lower inherent risk of loss than other real estate portfolio segments, although this is not always true as evidenced by the period 2007 through 2010. 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, DFI 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 Loan Losses

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

The Central Valley of California has been one of the hardest hit areas in the country during this recession. Housing prices in many areas are down as much as 60% and the economic stress has spread from residential real estate to other industry segments such as autos and commercial real estate. Unemployment levels are above 15% in many areas. Accordingly, during the second quarter of 2009, management and the Board of Directors began significantly increasing the Company’s loan loss allowance and as of December 31, 2010, the balance was $32.3 million or 2.74% of total loans. This represents a $2.4 million or 8.2% increase over December 31, 2009, and a $11.7 million or 57.4% increase over March 31, 2009. Although, in management’s opinion, the Company’s levels of net charge-offs and non-performing assets as of December 31, 2010, compare very favorably to our peers at the present time, no significant recovery has yet begun in our local markets and this has resulted in continuing borrower stress.

The provision for loan losses totaled $14.7 million in 2010 compared to $15.4 million in 2009 and $8.0 million in 2008. Net charge-offs during 2010 were $12.3 million compared to $5.6 million in 2009 and $6.4 million in 2008. Net charge-offs represented ––––1.04% of average loans during 2010, a level that in management’s opinion compares very favorably to the Company’s peers at the present time. See “Overview – Looking Forward: 2011 and Beyond,” “Critical Accounting Policies and Estimates – Allowance for Loan Losses” and “Item 7A. Quantitative and Qualitative Disclosures About Market Risk-Credit Risk.”

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The following tables summarize the activity and the allocation of the allowance for losses for the years indicated.

(in thousands)	2010	2009	2008	2007	2006
Allowance for Loan Losses					
Beginning of Year	$ 29,813	$ 20,034	$ 18,483	$ 18,099	$ 17,860
Provision Charged to Expense	14,735	15,420	7,998	1,495	275
Charge Offs:					
Commercial Real Estate	1,629	-	-	-	-
Agricultural Real Estate	559	-	-	-	-
Real Estate Construction	4,095	641	4,648	-	-
Residential 1st Mortgages	759	749	192	-	-
Home Equity Lines and Loans	310	391	-	-	-
Agricultural	916	123	209	254	333
Commercial	4,143	3,868	1,405	722	121
Consumer	112	159	98	52	41
Credit Card	-	-	124	202	284
Other	-	-	101	143	60
Total Charge Offs	12,523	5,931	6,777	1,373	839
Recoveries:					
Commercial Real Estate	-	-	-	-	-
Agricultural Real Estate	2	-	-	-	-
Real Estate Construction	-	-	-	-	-
Residential 1st Mortgages	7	3	-	-	-
Home Equity Lines and Loans	-	1	-	-	-
Agricultural	68	50	60	79	75
Commercial	92	104	143	30	624
Consumer	67	132	9	11	37
Credit Card	-	-	27	42	26
Other	-	-	91	100	41
Total Recoveries	236	290	330	262	803
Net Charge-Offs	(12,287)	(5,641)	(6,447)	(1,111)	(36)
Total Allowance for Loan Losses	$ 32,261	$ 29,813	$ 20,034	$ 18,483	$ 18,099
Ratios:					
Allowance for Loan Losses to:					
Total Loans at Year End	2.74 %	2.45 %	1.70 %	1.62 %	1.72 %
Average Loans	2.73 %	2.52 %	1.77 %	1.70 %	1.81 %
Consolidated Net Charge-Offs to:					
Loans at Year End	1.04 %	0.46 %	0.55 %	0.10 %	0.00 %
Average Loans	1.04 %	0.48 %	0.57 %	0.10 %	0.00 %

	Allowance Allocation at December 31,									
	2010		2009		2008		2007		2006	
(in thousands)	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent
Commercial Real Estate	$7,631	2.4 %	$12,845	4.4 %	$3,547	1.3 %	$2,527	0.6 %	$4,175	1.0 %
Agricultural Real Estate*	1,539	0.6 %	1,099	0.4 %	1,683	0.7 %				
	2,160	5.8 %	4,089	5.7 %	1,514	2.0 %	2,896	3.6 %	880	0.9 %

Real Estate Construction										
Residential 1st Mortgages	1,164	1.1 %	552	0.5 %	992	0.9 %	1,652	1.5 %	1,373	1.3 %
Home Equity Lines and Loans	3,724	6.3 %	1,349	2.1 %	1,781	2.7 %	836	1.3 %	436	0.6 %
Agricultural	6,733	2.9 %	2,298	1.1 %	4,432	2.0 %	5,335	2.5 %	3,564	1.9 %
Commercial	9,084	5.5 %	6,449	3.4 %	4,933	2.4 %	3,923	2.0 %	6,007	3.6 %
Consumer & Other	216	2.5 %	325	2.9 %	926	6.8 %	1,161	5.8 %	1,291	6.1 %
Unallocated	10		807		226		153		373	
Total	$32,261	2.7 %	$29,813	2.5 %	$20,034	1.7 %	$18,483	1.6 %	$18,099	1.7 %

* Prior to 2008 the allowance related to Agricultural Real Estate was included with Commercial Real Estate

As of December 31, 2010, the allowance for loan losses was $32.3 million, which represented 2.74% of the total loan balance. At December 31, 2009, the allowance for loan losses was $29.8 million or 2.45% of the total loan balance. After reviewing all factors above, based upon information currently available, management concluded that the allowance for loan losses as of December 31, 2010, 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.

2010 Compared to 2009

Non-interest income totaled $17.2 million, a decrease of $1.0 million or 5.6% from non-interest income of $18.2 million for 2009.

Service charges on deposit accounts totaled $6.5 million, a decrease of $427,000 or 6.1% from service charges on deposit accounts of $6.9 million in 2009. This was due primarily to a decrease in fees related to the Company's Overdraft Privilege Service.

Net gain on investment securities was $2.9 million in 2010 compared to a net gain of $3.5 million for 2009. During 2009 and 2010 the Company sold mortgage-backed securities at a gain and, in anticipation of rising rates, invested the funds primarily in shorter-term agency securities. See "Financial Condition-Investment Securities" for a discussion of the Company's investment strategy.

Debit Card and ATM fees totaled $2.6 million, an increase of $346,000 or 15.4% over fees in 2009. These are: (1) fees earned by the Company when non-customers use our ATM's; and (2) fees paid to the Company by VISA merchants when the Company's VISA Money Card holders use their card to complete a purchase.

Gains on deferred compensation investments were $1.4 million in 2010 compared to gains of $1.8 million in 2009. The Company allows executives who participate in non-qualified deferred compensation plans to self-direct the investment of their vested balances. See Note 16. located in "Item 8. Financial Statements and Supplementary Data" for a description of these plans. Market value gains/losses on these plan balances fluctuate depending on the type of investments held and market 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 totaled $2.0 million in 2010, an increase of $141,000 or 7.7% from 2009. This increase was primarily due to the gain on sale of three properties classified as other real estate.

2009 Compared to 2008

Non-interest income totaled $18.2 million, an increase of $2.1 million or 13.3% from non-interest income of $16.1 million for 2008.

Service charges on deposit accounts totaled $6.9 million, a decrease of $188,000 or 2.6% from service charges on deposit accounts of $7.1 million in 2008. This was due primarily to a decrease in fees related to the Company's Overdraft Privilege Service.

Net gain on investment securities was $3.5 million in 2009 compared to a gain of $1.5 million for 2008. During 2009 the Company sold mortgage-backed securities at a gain and, in anticipation of rising rates, invested the funds primarily in shorter-term agency securities.

During the second quarter of 2008 the Company determined that providing credit card and merchant processing services through third party strategic partners would result in a stronger, more competitive set of products with the potential for increased growth in future earnings. The sale of the credit card portfolio resulted in a gain of $1.0 million and the merchant portfolio $1.9 million in 2008. The sale of the merchant portfolio also resulted in a decrease in Credit Card Merchants Fees in the amount of $1.1 million from 2008, with a corresponding decrease in Credit Card Merchant Expense.

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Debit Card and ATM fees totaled $2.2 million, an increase of $194,000 or 9.5% over fees in 2008. These are: (1) fees earned by the Company when non-customers use our ATM's; and (2) fees paid to the Company by VISA merchants when the Company's VISA Money Card holders use their card to complete a purchase.

Gains on deferred compensation investments were $1.8 million in 2009 compared to losses of $2.7 million in 2008. The Company allows executives who participate in non-qualified deferred compensation plans to self-direct the investment of their vested balances. Market value gains/losses on these plan balances fluctuate depending on the type of investments held and market 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 totaled $1.8 million in 2009, a decrease of $373,000 or 16.9% from 2008. This decrease was primarily due to the reduction of certain fees the Company no longer generates since the sale of the Credit Card and Merchant Card portfolios in June 2008.

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.

2010 Compared to 2009
Overall, non-interest expense totaled $43.9 million, a decrease of $2.5 million or 5.4% for the year ended December 31, 2010.

Salaries and employee benefits decreased $439,000 or 1.5% primarily related to reduced staffing costs and decreased security guard expense, partially offset by increased health insurance costs.

Gains on deferred compensation investments were $1.4 million in 2010 compared to gains of $1.8 million in 2009. The Company allows executives who participate in non-qualified deferred compensation plans to self-direct the investment of their vested balances. See Note 16. located in "Item 8. Financial Statements and Supplementary Data" for a description of these plans. Market value gains/losses on these plan balances fluctuate depending on the type of investments held and market 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.

Occupancy expense in 2010 totaled $2.4 million, a decrease of $293,000 or 10.8% from 2009. This decrease was due to reduced property taxes.

Equipment expense in 2010 totaled $2.6 million, an increase of $188,000 or 7.8% from 2009. This increase is due to increases in hardware and software maintenance contracts.

ORE holding costs totaled $1.2 million in 2010 as compared to $1.5 million in 2009. Due to the economic climate over the past two years the Company has acquired $8.0 million of other real estate, which includes a mix of raw land, residential finished lots and commercial buildings. See "Financial Condition – Classified Loans and Non-Performing Assets." Included in the $1.2 million for 2010 is $716,000 related to the establishment of a reserve for ORE valuation adjustments, as compared to $1.0 million in 2009.

The Company's total FDIC insurance costs decreased $210,000 in 2010 to $2.3 million, an 8.4% decrease from $2.5 million in 2009. The FDIC did not levy any special assessments in 2010. See "Supervision and Regulation – Deposit Insurance" for further discussion of the Company's deposit insurance.

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Other non-interest expense declined $1.0 million, or 15.6%, to $5.7 million in 2010 compared to $6.7 million in 2009. This decrease was due to: (1) reduced advertising and promotional costs; (2) reduced legal fees related to problem credits; (3) reduced cost of credit review services; and (4) reduced correspondent bank fees.

2009 Compared to 2008

Overall, non-interest expense totaled $46.4 million, an increase of $6.3 million or 15.8% for the year ended December 31, 2009.

Salaries and employee benefits increased $1.7 million or 6.4% primarily due to officer salary increases, which took place in April 2009.

Gains on deferred compensation investments were $1.8 million in 2009 compared to losses of $2.7 million in 2008. The Company allows executives who participate in non-qualified deferred compensation plans to self-direct the investment of their vested balances. Market value gains/losses on these plan balances fluctuate depending on the type of investments held and market 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.

Equipment expense in 2009 totaled $2.4 million, a decrease of $241,000 or 9.1% from 2008. In 2009, the Company converted its item processing, check imaging, and report generation systems from Wausau, Inc. to Summit Software, resulting in the elimination of the large annual maintenance contract payment to Wausau.

Credit Card Merchant Expense was zero in 2009. This was due to the sale of the merchant card portfolio during the second quarter of 2008.

ORE holding costs totaled $1.5 million in 2009 as compared to $2.2 in 2008. Due to the economic climate over the past two years the Company has acquired $8.4 million of other real estate, which includes a mix of raw land, residential finished lots and commercial buildings. Included in the $1.5 million is $1.0 million related to the establishment of a reserve for ORE valuation adjustments.

The Company's total FDIC insurance costs exceeded the same period in 2008 by $1.9 million, a 369.2% increase. The FDIC continued to increase rates in 2009 and levy special assessments on all banks.

Other non-interest expense declined $117,000, or 1.7%, to $6.7 million in 2009 compared to $6.8 million in 2008. This decrease was due to: (1) the elimination of certain costs associated with the Company's credit card portfolio, which was sold in June 2008; and (2) the decrease or elimination of other expenses that were determined not to be necessary for the successful operation of the Company.

Income Taxes

The provision for income taxes increased $854,000 during 2010. The effective tax rate in 2010 was 36.6% compared to 36.1% in 2009 and 37.4% in 2008. 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 loan 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.

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Financial Condition

Investment Securities

The investment portfolio provides the Company with an income alternative to loans. The debt securities in the Company's investment portfolio have historically been comprised primarily of Mortgage-backed securities issued by federal government-sponsored entities, U.S. Government Agencies and high grade bank-qualified municipals and bonds. Importantly, the Company never invested in the preferred stock or subordinated debt of Fannie Mae "FNMA" or Freddie Mac "FHLMC," classes of securities that resulted in losses for many banks in recent years.

The Company's investment portfolio at the end of 2010 was $499.8 million, an increase of $64.6 million or 14.8% from 2009. During 2010 the Company's deposit growth continued to out-strip loan growth, resulting in an increase in the investment portfolio. In addition, during 2010 the Company continued to sell some higher coupon 30 year mortgage-backed securities, which further increased the cash available for reinvestment.

The Company's investment portfolio at the end of 2009 was $435.2 million, an increase of $71.4 million or 19.6% from 2008. Since the beginning of 2009 the Company had generated a significant amount of excess liquidity because interest rates have been low and perceived market risks high, causing customers to move funds from the stock market and other investment vehicles to FDIC insured bank deposits. Additionally, given the drop in mortgage rates during the first nine months of 2009, many of our higher coupon 30 year mortgage-backed securities were prepaying quickly, and their market value gains disappearing. As a result, during 2009 the Company sold, for a gain of $3.5 million, approximately $74.3 million of primarily mortgage-backed securities. This further increased our excess cash position.

The Company's 2010 reinvestment strategy for the cash generated from security sales and deposit inflows was to initially purchase only short and medium term U.S. Government Agency securities to protect against future increases in market interest rates. However, by the fourth quarter of 2010 it was evident that market interest rates would not be increasing any time soon, so some purchases of 10 and 15-year mortgage-backed securities were made.

As of December 31, 2010 the Company held $66.8 million of municipal investments, of which $52.2 million were bank-qualified municipal bonds, all classified as held-to-maturity. No purchases of bank-qualified municipal bonds have been made for several years, but the increasing 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. As of December 31, 2010 eighty-seven percent of the Company's bank-qualified municipal bonds have an underlying credit rating, and all of these ratings are "investment grade." Of the thirteen percent ($6.9 million) of the portfolio that is not rated, the Company monitors the status of these issuers 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.

Not included in the investment portfolio are overnight investments in Federal Funds Sold. In 2010 average Federal Funds Sold were $37.9 million compared to $36.7 million in 2009. Overnight investments in Federal Funds Sold are an additional earning asset available to the Company. Historically, in order to earn interest on excess cash balances banks had to "sell" these balances (called "Federal Funds Sold") on an overnight basis to other banks. However, in late 2008 the FRB began paying interest on the deposits that banks maintained in their FRB accounts (which are also classified as Federal Funds Sold on the Company's balance sheets) providing an essentially risk-free alternative for earning interest on overnight cash balances. These balances earn interest at the Fed Funds rate, which has been 0.25% since December, 2008.

The Company classifies its investments as held-to-maturity, trading, or available-for-sale. 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, 2010 and 2009, 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.

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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	Held to Maturity	Available for Sale	Held to Maturity	Available for Sale	Held to Maturity
	2010		2009		2008	
U. S. Agency	$236,319	$-	$136,168	$-	$-	$-
Municipal	6,378	60,439	8,365	64,044	10,231	64,765
Mortgage-backed Securities	185,637	2,218	215,327	3,583	276,176	5,133
Other	6,522	2,280	5,689	1,990	5,432	1,992
Total Book Value	$434,856	$64,937	$365,549	$69,617	$291,839	$71,890
Fair Value	$434,856	$66,039	$365,549	$71,010	$291,839	$71,538

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, 2010. Non-taxable municipal securities have been calculated on a fully taxable equivalent basis.

December 31, 2010 (in thousands)	Fair Value	Average Yield	
U.S. Agency			
After one year through five years	$225,438	1.09	%
After five years through ten years	10,881	2.09	%
Total U.S. Agency Securities	236,319	1.14	%
Municipal - Non-Taxable			
After ten years	6,378	5.01	%
Total Non-Taxable Municipal Securities	6,378	5.01	%
Mortgage-backed Securities			
After five years through ten years	41,479	3.98	%
After ten years	144,158	3.57	%
Total Mortgage-backed Securities	185,637	3.66	%
Other			
One year or less	6,522	0.61	%
Total Other Securities	6,522	0.61	%
Total Investment Securities Available-for-Sale	$434,856	2.26	%

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, 2010. Non-taxable municipal securities have been calculated on a fully taxable equivalent basis.

December 31, 2010 (in thousands)	Book Value	Average Yield	
Municipal - Non-Taxable			
One year or less	$801	5.03	%
After one year through five years	6,883	3.52	%
After five years through ten years	40,823	4.05	%
After ten years	11,932	4.83	%

Total Non-Taxable Municipal Securities	60,439	4.16	%
Mortgage-backed Securities			
After one year through five years	2,218	3.85	%
Total Mortgage-Backed Securities	2,218	3.85	%
Other			
After five years through ten years	8	4.51	%
After ten years	2,272	2.27	%
Total Other Securities	2,280	2.28	%
Total Investment Securities Held-to-Maturity	$64,937	4.08	%

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Loans

Loans can be categorized by borrowing purpose and use of funds. Common examples of loans 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 LTV’s 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; CLTV’s do not exceed 80%; FICO scores are at or above 670; Total Debt Ratios do not exceed 45%; 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.

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.

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Each loan type involves risks specific to the: (i) borrower; (ii) collateral; and (iii) loan structure. See “Results of Operations - Provision and Allowance for Credit Losses” for a more detailed discussion of risks by loan type. The Company’s current underwriting policies and standards are designed to mitigate the risks involved in each loan type. The Company’s policies require that loans 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 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.

Most loans 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: (i) on both a fixed rate and adjustable rate basis; (ii) over different terms; and (iii) 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 portfolio at December 31, 2010, decreased $36.7 million or 3.0% from December 31, 2009, a reflection of the economic conditions in our marketplace. The Company did experience some growth in the commercial real estate and agricultural loans, market segments where the Company believes that current market rates and/or credit risks are more reasonable than in other loan segments. Growth in commercial real estate was carefully focused on owner-occupied buildings or investment properties with reasonable LTV’s and borrower personal guarantees.

Beginning in late 2006 and continuing through 2010, the Company purposely reduced its exposure to real estate construction loans as the residential housing market softened. Additionally, the Company’s residential 1st mortgage portfolio is comprised primarily of 15 and 20-year mortgages to local customers. The Company does not originate sub-prime residential mortgage loans, nor does it hold any in its loan portfolio.

On an average balance basis, loans have decreased $4.4 million or 0.4%. In 2009 average balances increased 4.7% or $53.7 million from the prior year. The following table sets forth the distribution of the loan portfolio by type and percent as of December 31st of the years indicated. (in thousands)

	2010		2009		2008		2007		2006	
	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent
Commercial Real Estate	$318,341	27.0 %	$290,473	23.9 %	$271,856	23.0 %	$245,926	21.5 %	$242,033	23.1 %
Agricultural Real Estate	254,575	21.6 %	260,000	21.4 %	227,166	19.3 %	207,889	18.2 %	168,425	16.1 %
Real Estate Construction	37,486	3.2 %	71,647	5.9 %	75,472					