

FIRST FARMERS & MERCHANTS CORP  
Form 10-Q  
August 06, 2010  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

(Mark one)

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

For the quarterly period ended June 30, 2010

or

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Numbers: 000-10972

## First Farmers and Merchants Corporation

(Exact name of registrant as specified in its charter)

**Tennessee**

(State or other jurisdiction of incorporation or organization)

**62-1148660**

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

**816 South Garden Street**

**Columbia, Tennessee**

(Address of principal executive offices)

**38402-1148**

(Zip Code)

**931-388-3145**

(Registrant's telephone number, including area code)

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

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

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

(Do not check if a smaller reporting company)

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

As of August 5, 2010, the registrant had 5,487,713 shares of common stock outstanding.



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**PART I - FINANCIAL INFORMATION**

**Item 1. Financial Statements.**

The following unaudited consolidated financial statements of the Registrant and its subsidiaries are included in this Report:

Consolidated balance sheets - June 30, 2010 and December 31, 2009.

Consolidated statements of income - For the three months and six months ended June 30, 2010 and June 30, 2009.

Consolidated statements of cash flows - For the six months ended June 30, 2010 and June 30, 2009.

Selected notes to consolidated financial statements.

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**FIRST FARMERS AND MERCHANTS CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED BALANCE SHEETS**

| (Dollars in Thousands, Except Per Share Data)   | June 30,<br>2010<br>(Unaudited) | December 31,<br>2009<br>(1) |
|---|---------------------------------|-----------------------------|
| <b>ASSETS</b>   |                                 |                             |
| Cash and due from banks   | \$ 15,364                       | \$ 11,181                   |
| Interest-bearing due from banks   | 3,959                           | 5,557                       |
| Federal funds sold  | 27,500                          | 16,725                      |
| Total cash and cash equivalents   | 46,823                          | 33,463                      |
| Securities  |                                 |                             |
| Available-for-sale (amortized cost \$209,730 and \$207,027, respectively)   | 212,392                         | 208,238                     |
| Held-to-maturity (fair market value \$41,685 and \$48,722, respectively)  | 40,678                          | 47,613                      |
| Total securities  | 253,070                         | 255,851                     |
| Loans, net of deferred fees   | 573,293                         | 576,655                     |
| Allowance for loan and lease losses   | (9,337)                         | (8,929)                     |
| Net loans   | 563,956                         | 567,726                     |
| Bank premises and equipment, at cost less allowance for depreciation  | 21,900                          | 20,625                      |
| Core deposit and other intangibles  | 9,074                           | 9,111                       |
| Other assets  | 49,224                          | 48,252                      |
| <b>TOTAL ASSETS</b>   | <b>\$ 944,047</b>               | <b>\$ 935,028</b>           |
| <b>LIABILITIES</b>  |                                 |                             |
| Deposits  |                                 |                             |
| Noninterest-bearing   | \$ 122,543                      | \$ 116,157                  |
| Interest-bearing (including certificates of deposits over \$100: 2010 - \$104,704; 2009 - \$97,572)   | 664,841                         | 656,168                     |
| Total deposits  | 787,384                         | 772,325                     |
| Federal funds purchased and securities sold under agreements to repurchase  | 4,996                           | 5,856                       |
| Dividends payable   | 2,030                           | 2,038                       |
| Short-term borrowings   | 420                             | 414                         |
| Accounts payable and accrued liabilities  | 13,706                          | 13,045                      |
| Federal Home Loan Bank Advances   | 27,177                          | 34,177                      |
| <b>TOTAL LIABILITIES</b>  | <b>835,713</b>                  | <b>827,855</b>              |
| <b>SHAREHOLDERS EQUITY</b>  |                                 |                             |
| Common stock - \$10 par value per share, 8,000,000 shares authorized; 5,487,713 and 5,506,993 shares issued and outstanding as of June 30, 2010 and December 31, 2009, respectively | 54,877                          | 55,070                      |
| Retained earnings   | 51,725                          | 51,264                      |
| Accumulated other comprehensive income  | 1,637                           | 744                         |
| <b>TOTAL SHAREHOLDERS EQUITY BEFORE NONCONTROLLING INTEREST - PREFERRED STOCK OF SUBSIDIARY</b>   | <b>108,239</b>                  | <b>107,078</b>              |
| Noncontrolling interest - preferred stock of subsidiary   | 95                              | 95                          |
| <b>TOTAL LIABILITIES AND SHAREHOLDERS EQUITY</b>  | <b>\$ 944,047</b>               | <b>\$ 935,028</b>           |

(1) Derived from audited financial statements.

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



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**FIRST FARMERS AND MERCHANTS CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF INCOME**

| (Dollars in Thousands Except Per Share Data)<br>(Unaudited)                            | Three Months Ended<br>June 30, |                 | Six Months Ended<br>June 30, |                 |
|--|--------------------------------|-----------------|------------------------------|-----------------|
|  | 2010                           | 2009            | 2010                         | 2009            |
| <b>INTEREST AND DIVIDEND INCOME</b>  |                                |                 |                              |                 |
| Interest and fees on loans   | \$ 8,058                       | \$ 7,910        | \$ 15,932                    | \$ 15,777       |
| Income on investment securities  |                                |                 |                              |                 |
| Taxable interest   | 1,173                          | 1,119           | 2,357                        | 2,445           |
| Exempt from federal income tax   | 878                            | 946             | 1,774                        | 1,920           |
| Dividends  | 55                             | 46              | 102                          | 106             |
|  | 2,106                          | 2,111           | 4,233                        | 4,471           |
| Other interest income  | 10                             | 27              | 28                           | 44              |
| <b>TOTAL INTEREST INCOME</b>   | <b>10,174</b>                  | <b>10,048</b>   | <b>20,193</b>                | <b>20,292</b>   |
| <b>INTEREST EXPENSE</b>  |                                |                 |                              |                 |
| Interest on deposits   | 1,535                          | 2,083           | 3,188                        | 4,327           |
| Interest on other borrowings   | 250                            | 291             | 524                          | 603             |
| <b>TOTAL INTEREST EXPENSE</b>  | <b>1,785</b>                   | <b>2,374</b>    | <b>3,712</b>                 | <b>4,930</b>    |
| <b>NET INTEREST INCOME</b>   | <b>8,389</b>                   | <b>7,674</b>    | <b>16,481</b>                | <b>15,362</b>   |
| PROVISION FOR POSSIBLE LOAN AND LEASE LOSSES   | 405                            | 770             | 1,491                        | 1,425           |
| <b>NET INTEREST INCOME AFTER PROVISION FOR LOAN AND LEASE LOSSES</b>                   | <b>7,984</b>                   | <b>6,904</b>    | <b>14,990</b>                | <b>13,937</b>   |
| <b>NONINTEREST INCOME</b>  |                                |                 |                              |                 |
| Trust department income  | 465                            | 436             | 1,025                        | 994             |
| Service fees on deposit accounts   | 1,797                          | 1,833           | 3,406                        | 3,555           |
| Other fees and commissions   | 142                            | 156             | 257                          | 240             |
| Other operating (loss) income  | (112)                          | 267             | (61)                         | 367             |
| Securities (loss) gains  | (1)                            | 528             | 502                          | 2,482           |
| <b>TOTAL NONINTEREST INCOME</b>  | <b>2,291</b>                   | <b>3,220</b>    | <b>5,129</b>                 | <b>7,638</b>    |
| <b>NONINTEREST EXPENSE</b>   |                                |                 |                              |                 |
| Salaries and employee benefits   | 4,064                          | 4,143           | 8,180                        | 8,313           |
| Net occupancy expense  | 673                            | 628             | 1,314                        | 1,269           |
| Furniture and equipment expense  | 274                            | 220             | 532                          | 548             |
| Other operating expenses   | 3,128                          | 3,179           | 6,833                        | 6,086           |
| <b>TOTAL NONINTEREST EXPENSES</b>  | <b>8,139</b>                   | <b>8,170</b>    | <b>16,859</b>                | <b>16,216</b>   |
| <b>INCOME BEFORE PROVISION FOR INCOME TAXES</b>  | <b>2,136</b>                   | <b>1,954</b>    | <b>3,260</b>                 | <b>5,359</b>    |
| PROVISION FOR INCOME TAXES   | 196                            | 229             | 128                          | 926             |
| Net income before noncontrolling interest - dividends on preferred stock of subsidiary | \$ 1,940                       | \$ 1,725        | \$ 3,132                     | \$ 4,433        |
| Noncontrolling interest - dividends on preferred stock of subsidiary                   | \$                             | \$              | \$                           | \$              |
| <b>NET INCOME AVAILABLE FOR COMMON SHAREHOLDERS</b>                                    | <b>\$ 1,940</b>                | <b>\$ 1,725</b> | <b>\$ 3,132</b>              | <b>\$ 4,433</b> |
| <b>BASIC EARNINGS PER SHARE</b>  |                                |                 |                              |                 |
| Weighted Average Shares Outstanding  | 5,487,729                      | 5,547,088       | 5,495,835                    | 5,560,856       |
|  | \$ 0.35                        | \$ 0.31         | \$ 0.57                      | \$ 0.80         |

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

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**FIRST FARMERS AND MERCHANTS CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**

| (Dollars in Thousands)   | Six months ended June 30, |           |
|--|---------------------------|-----------|
|  | 2010                      | 2009      |
| <b>OPERATING ACTIVITIES</b>  |                           |           |
| Net income available for common shareholders   | \$ 3,132                  | \$ 4,433  |
| Adjustments to reconcile net income to net cash provided by operating activities         |                           |           |
| Excess (deficiency) of provision for possible loan and lease losses over net charge-offs | 1,491                     | (415)     |
| Provision for depreciation and amortization of premises and equipment                    | 605                       | 571       |
| Securities gains   | (502)                     | (2,482)   |
| Loss from disposition of fixed assets  |                           | 129       |
| Loss (gain) from disposition of other real estate  | 268                       | (6)       |
| Amortization of deposit base intangibles   | 37                        | 37        |
| Amortization of investment security premiums, net of accretion of discounts              | 870                       | 511       |
| Increase in cash surrender value of life insurance contracts                             | (434)                     | (15)      |
| (Increase) decrease in   |                           |           |
| Deferred income taxes  | (467)                     | 457       |
| Interest receivable  | 360                       | (108)     |
| Other real estate owned  | (2,802)                   | (3,623)   |
| Other assets   | 413                       |           |
| (Decrease) increase in   |                           |           |
| Interest payable   | (65)                      | (397)     |
| Other liabilities  | 726                       | 1,207     |
| Total adjustments  | 500                       | (4,134)   |
| Net cash provided by operating activities  | 3,632                     | 299       |
| <b>INVESTING ACTIVITIES</b>  |                           |           |
| Proceeds from maturities, calls, and sales of available-for-sale securities              | 95,732                    | 148,217   |
| Proceeds from maturities and calls of held-to-maturity securities                        | 6,905                     | 7,834     |
| Purchases of investment securities   |                           |           |
| Available-for-sale   | (98,772)                  | (164,554) |
| Held-to-maturity   |                           |           |
| Net increase (decrease) in loans   | 2,280                     | (3,008)   |
| Proceeds from sale of foreclosed assets  | 1,597                     | 41        |
| Purchase of life insurance premium   | (468)                     | (235)     |
| Purchases of premises and equipment  | (1,880)                   | (3,628)   |
| Net cash provided by (used in) investing activities                                      | 5,394                     | (15,333)  |
| <b>FINANCING ACTIVITIES</b>  |                           |           |
| Net increase in noninterest-bearing and interest-bearing deposits                        | 15,059                    | 41,520    |
| Net (increase) decrease in short term borrowings   | (854)                     | 90        |
| Payments to FHLB borrowings  | (7,000)                   | (7,000)   |
| Repurchase of common stock   | (833)                     | (2,500)   |
| Cash dividends paid on common stock  | (2,038)                   | (2,000)   |
| Net cash provided by financing activities  | 4,334                     | 30,110    |
| Increase in cash and cash equivalents  | 13,360                    | 15,076    |
| Cash and cash equivalents at beginning of period   | 33,463                    | 31,536    |
| Cash and cash equivalents at end of period   | \$ 46,823                 | \$ 46,612 |

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



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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**NOTE 1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

The interim unaudited consolidated financial statements of First Farmers and Merchants Corporation (the Corporation) presented in this report have been prepared on a consistent basis and in accordance with the instructions to Form 10-Q and do not include all of the information and notes required by generally accepted accounting principles for complete financial statements. Management has evaluated all significant events and transactions that occurred through August 5, 2010, for potential recognition or disclosure in these consolidated financial statements. In the opinion of management, all adjustments considered necessary for a fair presentation have been included. These adjustments were of a normal, recurring nature and consistent with generally accepted accounting principles. For further information, refer to the consolidated financial statements and notes included in the Corporation's Annual Report on Form 10-K for the year ended December 31, 2009.

**NOTE 2 STOCK REPURCHASE**

During the second quarter of 2010, the Corporation repurchased, from third-party sellers, 1,500 shares of the Corporation's common stock at a previously negotiated price of \$43.20 per share for an aggregate purchase price of \$64,800.

**NOTE 3 FAIR VALUE MEASUREMENT**

The fair value of an asset or liability is the price that would be received to sell that asset or paid to transfer that liability in an orderly transaction occurring in the principal market (or most advantageous market in the absence of a principal market) for such asset or liability. In estimating fair value, the Corporation utilizes valuation techniques that are consistent with the market approach, the income approach and/or the cost approach. Such valuation techniques are consistently applied. Inputs to valuation techniques include the assumptions that market participants would use in pricing an asset or liability. Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Topic 820, Fair Value Measurements and Disclosures, establishes a fair value hierarchy for valuation inputs that gives the highest priority to quoted prices in active markets for identical assets or liabilities and the lowest priority to unobservable inputs. The fair value hierarchy is as follows:

- *Level 1 Inputs* - Unadjusted quoted prices in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date.
- *Level 2 Inputs* - Inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. These might include quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, inputs other than quoted prices that are observable for the asset or liability (such as interest rates, volatilities, prepayment speeds, credit risks, etc.) or inputs that are derived principally from or corroborated by market data by correlation or other means.

- *Level 3 Inputs* - Unobservable inputs for determining the fair values of assets or liabilities that reflect an entity's own assumptions about the assumptions that market participants would use in pricing the assets or liabilities.

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Assets measured at fair value on a recurring basis comprised the following at June 30, 2010:

| (Dollars in thousands)                     | Fair Value Measurements at Reporting Date Using |   |   |   |
|--|---|---|---|---|
|  | Fair Value<br>6/30/2010                         | Quoted Prices in<br>Active Markets for<br>Identical Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs (Level 3) |
| <b>Obligations of:</b>                     |   |   |   |   |
| U.S. Government agencies                   | \$ 114,889                                      | \$  | \$ 114,889  | \$  |
| States and political subdivisions          | 50,008  |   | 50,008  |   |
| Residential mortgage-backed securities     | 27,549  |   | 27,549  |   |
| Other domestic debt securities             | 16,049  |   | 16,049  |   |
| Equity securities                          | 3,897   |   | 3,897   |   |
| <b>Total available-for-sale securities</b> | <b>\$ 212,392</b>                               | <b>\$</b>   | <b>\$ 212,392</b>   | <b>\$</b>                                       |

The fair values used by the Corporation are obtained from an independent pricing service and represent either quoted market prices for the identical securities (Level 1 inputs) or fair values determined by pricing models using a market approach that consider observable market data, such as interest rate volatilities, LIBOR yield curve, credit spreads and prices from market makers and live trading systems (Level 2).

Certain financial assets and liabilities are measured at fair value on a nonrecurring basis. These instruments are not measured at fair value on an ongoing basis but are subject to fair value adjustments in certain circumstances (for example, when there is evidence of impairment). The only financial asset or liability measured at fair value on a non-recurring basis for the second quarter of 2010 was impaired loans.

*Impaired loans* Certain impaired loans are reported at the fair value of the underlying collateral if repayment is expected solely from the collateral. Collateral values are estimated using Level 2 inputs based on observable market data or Level 3 inputs based on customized discounting criteria. During the second quarter of 2010, certain impaired loans were reevaluated and reported at fair value through a specific valuation allowance allocation to the allowance for possible loan and lease losses based on the fair value of the underlying collateral. Impaired loans with a carrying value of \$20.7 million were reduced by specific valuation allowance allocations totaling \$1.9 million to a total reported fair value of \$18.8 million based on collateral valuations utilizing Level 3 valuation inputs.

*Non-Financial Assets and Non-Financial Liabilities* The Corporation has no non-financial assets or non-financial liabilities measured at fair value on a recurring basis. Certain non-financial assets and non-financial liabilities measured at fair value on a non-recurring basis include foreclosed assets (upon initial recognition or subsequent impairment), non-financial assets and non-financial liabilities measured at fair value in the second step of goodwill impairment test, and intangible assets and other non-financial long-lived assets measured at fair value for impairment assessment.

During the second quarter of 2010, certain foreclosed assets, upon initial recognition, were remeasured and reported at fair value through a charge-off to the allowance for possible loan and lease losses based upon the fair value of the foreclosed asset. The fair value of a foreclosed asset, upon initial recognition, is estimated using Level 2 inputs based on observable market data or Level 3 inputs based on customized discounting criteria. Foreclosed assets measured at fair value totaled \$10.9 million (utilizing Level 2 valuation inputs) at June 30, 2010.

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The table below presents the fair value of financial assets and financial liabilities, including those financial assets and financial liabilities that are not measured and reported at fair value on a recurring basis or non-recurring basis. A detailed description of the valuation methodologies used in estimating the fair value of financial instruments is set forth in Note 12 to the consolidated financial statements incorporated by reference into the Corporation's Annual Report on Form 10-K for the year ended December 31, 2009.

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The estimated fair values of financial instruments were as follows (dollars in thousands):

|  | June 30, 2010   |            | December 31, 2009 |            |
|--|-----------------|------------|-------------------|------------|
|  | Carrying Amount | Fair Value | Carrying Amount   | Fair Value |
| <b>Financial assets</b>  |                 |            |                   |            |
| Cash and due from banks  | \$ 15,364       | \$ 15,364  | \$ 11,181         | \$ 11,181  |
| Interest-bearing deposits in banks   | 3,959           | 3,959      | 5,557             | 5,557      |
| Federal funds sold   | 27,500          | 27,500     | 16,725            | 16,725     |
| Securities available-for-sale  | 212,392         | 212,392    | 208,238           | 208,238    |
| Securities held-to-maturity  | 40,678          | 41,685     | 47,613            | 48,722     |
| Loans, net   | 563,956         | 573,879    | 567,726           | 570,975    |
| Accrued interest receivable  | 4,089           | 4,089      | 4,449             | 4,449      |
| <b>Financial liabilities</b>   |                 |            |                   |            |
| Deposits   | 787,384         | 789,130    | 772,325           | 773,710    |
| Federal funds purchased and securities sold under agreements to repurchase | 4,996           | 4,996      | 5,856             | 5,856      |
| Other short term liabilities   | 420             | 420        | 414               | 414        |
| FHLB borrowings  | 27,177          | 28,202     | 34,177            | 38,616     |
| Accrued interest payable   | 1,119           | 1,119      | 1,184             | 1,184      |
| <b>Off-balance sheet credit related instruments:</b>                       |                 |            |                   |            |
| Commitments to extend credit   |                 | 103        |                   | 103        |

A description of the valuation methodologies used for instruments measured at fair value as well as the general classification of such instruments pursuant to the valuation hierarchy is set forth below. These valuation methodologies were applied to all of the financial assets and financial liabilities of the Corporation and its sole wholly-owned subsidiary, First Farmers and Merchants Bank (the "Bank"), carried at fair value effective June 30, 2010. If quoted market prices are not available, fair value is based on internally developed models that primarily use, as inputs, observable market-based parameters. Valuation adjustments may be made to ensure that financial instruments are recorded at fair value. These adjustments may include amounts to reflect counterparty credit quality and the Corporation's creditworthiness among other things, as well as unobservable parameters. Any such valuation adjustments are applied consistently over time. The Corporation's valuation methodologies may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. While management believes the valuation methodologies are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different estimate of fair value at the reporting date. Furthermore, the reported fair value amounts have not been comprehensively revalued since the presentation dates and, therefore, estimates of fair value after the balance sheet date may differ significantly from the amounts presented herein.

Financial assets and financial liabilities measured at fair value on a recurring basis include the following:

**Loans:** The fair value of portfolio loans assumes sale of the notes to a third party financial investor. Accordingly, this value is not necessarily the value to the Corporation if the notes were held to maturity. The Corporation considered interest rate, credit and market factors in estimating the fair value of loans. In the current whole loan market, financial investors are generally requiring a much higher rate of return than the return inherent in loans if held to maturity given the lack of market liquidity. This divergence accounts for the majority of the difference in carrying amount over fair value.

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**Deposits:** The fair value of fixed maturity certificates of deposit is estimated using a discounted cash flow calculation based on current rates offered for deposits of similar remaining maturities.

**FHLB Borrowings:** The fair value of Federal Home Loan Bank of Cincinnati (the FHLB ) borrowings is estimated using discounted cash flow analysis based on rates currently available to the Corporation for borrowings with similar terms.

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The Bank has a Blanket Agreement for Advances and Security Agreement (the Blanket Agreement) with the FHLB dated March 31, 2008. Advances made to the Bank under the Blanket Agreement are collateralized by FHLB stock and unidentified qualifying residential mortgage loans totaling 150% of the outstanding amount borrowed. The Bank made an annual principal payment of \$7.0 million to the FHLB under the Blanket Agreement on each of March 31, 2009 and March 31, 2010.

Scheduled principal maturities of borrowings under this credit line as of June 30, 2010, are as follows (dollars in thousands):

|       |    |        |
|-------|----|--------|
| 2010  | \$ | 3,077  |
| 2011  |    | 7,000  |
| 2012  |    | 7,000  |
| 2013  |    | 10,100 |
| Total | \$ | 27,177 |

Stock held in the FHLB totaling \$3.0 million at June 30, 2010 is carried at cost. The stock is restricted and can only be sold to the FHLB at par.

The Bank also has a Cash Management Advance Line of Credit Agreement (the CMA) dated March 31, 2009, with the FHLB. The CMA is a component of the Blanket Agreement. The purpose of the CMA is to assist with short-term liquidity management. Under the terms of the CMA, the Bank may borrow a maximum of \$40.0 million, selecting a variable rate of interest for up to 90 days or a fixed rate for a maximum of 30 days. There were no borrowings outstanding under the CMA as of June 30, 2010.

**NOTE 5 SECURITIES**

Securities with an amortized cost of \$169.9 million and a fair value of \$171.9 million at June 30, 2010 were pledged to secure deposits and for other purposes as required or permitted by law. The fair value is established by an independent pricing service as of the approximate dates indicated. The differences between the amortized cost and fair value reflect current interest rates and represent the potential gain if the portfolio had been liquidated on that date. Security gains are realized only in the event of dispositions prior to maturity.

A summary of the amortized cost and estimated fair value of securities at June 30, 2010 is as follows (dollars in thousands):

|                               | Amortized<br>Cost | Gains    | Gross Unrealized<br>Losses | Fair<br>Value |
|-------------------------------|-------------------|----------|----------------------------|---------------|
| <b>June 30, 2010</b>          |                   |          |                            |               |
| Available-for-sale securities |                   |          |                            |               |
| U.S. Government agencies      | \$ 113,889        | \$ 1,000 | \$                         | \$ 114,889    |

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|                                    |            |          |        |            |
|------------------------------------|------------|----------|--------|------------|
| Mortgage backed securities         | 27,138     | 411      |        | 27,549     |
| States and political subdivisions  | 49,306     | 892      | 190    | 50,008     |
| Other securities                   | 19,397     | 565      | 16     | 19,946     |
|                                    | \$ 209,730 | \$ 2,868 | \$ 206 | \$ 212,392 |
| <b>Held-to-maturity securities</b> |            |          |        |            |
| States and political subdivisions  | \$ 40,678  | \$ 1,060 | \$ 53  | \$ 41,685  |
|                                    | \$ 40,678  | \$ 1,060 | \$ 53  | \$ 41,685  |

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At June 30, 2010, the Bank did not hold investment securities of any single issuer, other than obligations of the U.S. government agencies, whose aggregate book value exceeded 10% of shareholders' equity.

Proceeds from the maturity, call or sale of available-for-sale securities were \$95.7 million during the six months ended June 30, 2010. Proceeds from the maturity or call of held-to-maturity securities were \$6.9 million during the six months ended June 30, 2009.

The fair values of all securities at June 30, 2010 either equaled or exceeded the cost of those securities, or the fair value is considered temporary. The information in the table below classifies the investments with unrealized losses at June 30, 2010 according to the term of the unrealized loss. Management evaluates securities for other-than-temporary impairment periodically, or more frequently when circumstances require an evaluation. An impairment judgment is based on (i) the amount of time and loss, (ii) the financial condition of the issuer and (iii) management's intent and ability to hold the investment long enough for any anticipated recovery in value.

Management has the ability and intent to hold the securities classified as held-to-maturity until they mature. Furthermore, as of June 30, 2010, management also had the ability to hold the securities classified as available for sale for a period of time sufficient for a recovery of cost. The unrealized losses are largely as a result of increases in market interest rates over the yield available at the time the underlying securities were purchased. The fair value is expected to recover as the bonds approach their maturity date or repricing date or if market yields for such investments decline. Management does not believe any of the securities are impaired because of reasons of credit quality. Accordingly, as of June 30, 2010, management believes the impairments detailed in the table below are temporary and no impairment loss has been realized in the Corporation's consolidated income statement.

The following table presents the Bank's investments with unrealized losses at June 30, 2010 according to the term of the unrealized loss:

| (Dollars in thousands)                   | Less than 12 months |                   | 12 months or greater |                   | Total      |                   |
|--|---------------------|-------------------|----------------------|-------------------|------------|-------------------|
|  | Fair Value          | Unrealized Losses | Fair Value           | Unrealized Losses | Fair Value | Unrealized Losses |
| <b>Type of Security</b>                  |                     |                   |                      |                   |            |                   |
| <b>States and political subdivisions</b> | \$ 9,405            | 208               | \$ 415               | \$ 35             | \$ 9,820   | \$ 243            |
| <b>Corporate bonds</b>                   | 1,622               | 16                |                      |                   | 1,622      | 16                |
|  | \$ 11,027           | \$ 224            | \$ 415               | \$ 35             | \$ 11,442  | \$ 259            |

At June 30, 2010, one of 192 state and political subdivision securities had recorded unrealized losses for a period longer than 12 months. Because these securities, along with the corporation securities, declined in value when interest rates began to rise, and not because of the credit quality of the issuer, and because management had both the intent and ability to hold the investments, the securities were not considered other-than-temporarily impaired.

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The table below shows the amortized cost and fair value of investment securities at June 30, 2010 by contractual or legal maturity. Expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations. Mortgage-backed securities and equity securities are shown separately since they are not due at a single maturity date.

| (Dollars in Thousands)               | Amortized<br>Cost | Fair<br>Value | Yield<br>(Unaudited) |
|--------------------------------------|-------------------|---------------|----------------------|
| <b>Available-for-sale securities</b> |                   |               |                      |
| U.S. Government agencies             |                   |               |                      |
| Within one year                      | \$ 10,902         | \$ 10,907     | 2.2%                 |
| After one but within five years      | 43,631            | 43,938        | 1.7%                 |
| After five but within ten years      | 59,356            | 60,044        | 4.6%                 |
| Mortgage backed securities           |                   |               |                      |
| Within one year                      | 6,738             | 6,750         | 1.5%                 |
| After one but within five years      | 15,681            | 15,933        | 2.9%                 |
| After five but within ten years      | 4,719             | 4,865         | 3.8%                 |
| States and political subdivisions    |                   |               |                      |
| Within one year                      | 205               | 205           | 11.0%                |
| After one but within five years      | 6,426             | 6,640         | 3.8%                 |
| After five but within ten years      | 5,070             | 5,086         | 5.4%                 |
| After ten years                      | 37,605            | 38,078        | 6.1%                 |
| Other securities                     |                   |               |                      |
| Within one year                      | 1,645             | 1,676         | 4.4%                 |
| After one but within five years      | 13,396            | 13,884        | 3.4%                 |
| After five but within ten years      | 459               | 489           | 4.5%                 |
| After ten years                      | 3,897             | 3,897         | 0.7%                 |
|                                      | \$ 209,730        | \$ 212,392    |                      |
| <b>Held-to-maturity securities</b>   |                   |               |                      |
| States and political subdivisions    |                   |               |                      |
| Within one year                      | \$ 480            | \$ 481        | 6.8%                 |
| After one but within five years      | 10,461            | 10,802        | 7.0%                 |
| After five but within ten years      | 10,968            | 11,296        | 6.4%                 |
| After ten years                      | 18,769            | 19,106        | 6.2%                 |
|                                      | \$ 40,678         | \$ 41,685     |                      |

**NOTE 6 RECENT ACCOUNTING PRONOUNCEMENTS**

In January 2010, the FASB issued Accounting Standards Update ( ASU ) No. 2010-06, *Fair Value Measurements and Disclosures (Topic 820): Improving Disclosures about Fair Value Measurements*. This ASU requires fair value disclosures to be disaggregated below line items in the statement of financial position. It clarifies that fair value disclosures should include a description of the inputs and valuation techniques used for both recurring and nonrecurring Level 2 and Level 3 estimates. It also requires entities to disclose any significant transfers between Levels 1, 2, and 3 during a reporting period and the reasons the transfers were made. These disclosures have been included in this quarterly report on Form 10-Q, as appropriate.

On January 1, 2010, ASU No. 2009-16, *Transfers and Servicing (Topic 860): Accounting for Transfers of Financial Assets* became effective. This ASU removed the concept of a qualifying special-purpose entity from generally accepted accounting principles and changed the requirements for derecognizing financial assets. Upon adoption of the ASU, the Bank had no change in its balance sheet or required capital because off-balance sheet financing is not used.



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

**FORWARD-LOOKING STATEMENTS**

Certain statements contained in this report may not be based on historical facts and are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended (the Exchange Act). These forward-looking statements may be identified by, among other things, the use of forward-looking terminology such as could, would, expects, believes, may or will, or future or conditional verb tenses, and variations or negatives of such terms. These forward-looking statements include, without limitation, those relating to the Corporation's valuation methodologies, fair value of bonds, impairment of securities, repayment of loans, loan portfolio concentrations, fair value of impaired loans, satisfaction of capital adequacy requirements, payments on advances from the Federal Home Loan Bank of Cincinnati (the FHLB), adequacy of traditional sources of cash generated from operating activities to meet liquidity needs and the realization of deferred income tax assets. We caution you not to place undue reliance on such forward-looking statements in this report because results could differ materially from those anticipated due to a variety of factors. These factors include, but are not limited to, conditions in the financial market, liquidity needs, the sufficiency of our allowance for loan and lease losses (ALLL), economic conditions in the communities in the State of Tennessee where the Corporation does business, the impact of government regulation and supervision, interest rate risk, including changes in monetary policy and fluctuating interest rates, the Corporation's ability to attract and retain key personnel, competition from other financial services, the liquidity of the Corporation's common stock, other factors generally understood to affect the financial results of financial services companies and other factors detailed from time to time in our filings with the Securities and Exchange Commission (the SEC). We undertake no obligation to update these forward-looking statements to reflect events or circumstances that occur after the date of this report.

**EXECUTIVE OVERVIEW**

At June 30, 2010, the consolidated total assets of First Farmers and Merchants Corporation (the Corporation) were \$944.0 million, its consolidated net loans were \$564.0 million, its total deposits were \$787.4 million and its total shareholders' equity was \$108.3 million. The Corporation's loan portfolio at June 30, 2010 reflected a decrease of \$3.8 million, or 0.7%, compared to December 31, 2009. Total deposits increased \$15.1 million, or 2.0%, and shareholders' equity increased by 1.1% during the first six months of 2010. Total shareholders' equity includes an unrealized gain on available-for-sale securities of \$1.6 million.

**FINANCIAL CONDITION**

Average earning assets at June 30, 2010 were up 1.7%, or \$14.2 million, from average earning assets at December 31, 2009. Average overnight investments at June 30, 2010 were up 2.2% compared to December 31, 2009. Average investment securities at June 30, 2010 were up 11.1% compared to December 31, 2009. Average total assets of \$951.1 million at June 30, 2010 increased 3.1% or \$28.5 million, compared to \$922.6 million at December 31, 2009. The increases in average assets were primarily the result of an increase in investment securities.

Securities

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Available-for-sale securities are an integral part of the asset/liability management process for First Farmers and Merchants Bank (the Bank), the Corporation's sole direct subsidiary. Accordingly, they represent an important source of liquidity available to fund loans and accommodate asset reallocation strategies dictated by changes in the Bank's operating and tax plans, shifting yield spread relationships and changes in configuration of the yield curve. At June 30, 2010, the Bank's investment securities portfolio had \$212.4 million available-for-sale securities, which are valued at fair market value, and \$40.7 million held-to-maturity securities, which are valued at cost on the balance sheet. These compare to \$208.2 million of available-for-sale securities and \$47.6 million of held-to-maturity securities as of December 31, 2009.

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Loans

The loan portfolio is the largest component of earning assets for the Bank and, consequently, provides the highest amount of revenues for the Corporation. The loan portfolio also contains the highest exposure to risk as a result of the possibility of unexpected deterioration in the credit quality of borrowers. When analyzing potential loans, management of the Bank assesses both interest rate objectives and credit quality objectives in determining whether to make a given loan and the appropriate pricing for that loan. All loans are expected to be repaid from cash flow or proceeds from the sale of selected assets of the borrowers. Collateral requirements for the loan portfolio are based on credit evaluation of the borrowers.

The loan portfolio decreased slightly during the second quarter, making this the third consecutive quarterly decline in loans outstanding. Loan growth has been sluggish in 2010, as both the commercial and retail portfolios experienced some deterioration in the first six months of the year. The Bank continues to carry a concentration in 1-4 family residential first mortgage lending, but this portfolio declined in the first six months of 2010. On the commercial side, the Bank continues to experience growth in the non-farm, non-residential real estate portfolio. Over half of the Bank's exposure is in owner-occupied real estate, rather than commercial real estate, which is dependent on the lease, sale, or refinance of the underlying collateral. Higher reserves are being placed against property types which are perceived to be higher risk, such as retail and multi-family real estate.

Real estate loans represented 79.6% of total loans at June 30, 2010 compared to 77.0% at June 30, 2009 and 79.5% at December 31, 2009. Management of the Bank believes the risk of this concentration is acceptable given the quality of underwriting and the low level of historical loss experience. The Bank's construction and development portfolio has decreased by \$2.1 million in the last six months, as existing construction projects have been completed and few new projects have come in to replace them. Construction and development loans represented 6.0% of total loans as of June 30, 2010, compared to 4.8% at June 30, 2009 and 6.7% at December 31, 2009. The Bank continues to reserve more heavily against its construction and development portfolio than any other segment of the commercial portfolio, given the comparatively high level of losses that have been incurred within this segment of the portfolio over the previous year.

The analysis and review of asset quality by the Bank's credit administration includes a formal review that evaluates the adequacy of the allowance for possible loan and lease losses. This review is updated monthly and evaluated in more detail quarterly in conjunction with loan review reports and evaluations that are discussed in meetings with loan officers, credit administration and the Bank's Board of Directors. No reserve is placed against loans that are risk rated 1, as these loans are all cash-secured. A separate methodology is used for the criticized and classified portfolios (risk ratings 6-8), and the Bank's historical loss methodology is utilized for the pass-grade ratings (risk ratings 2-5) of the commercial portfolio. Several smaller segments of the commercial portfolio saw an increase in loss rates in the second quarter. Property types that are deemed to be higher-risk forms of collateral and present the highest likelihood of credit losses now carry correspondingly higher reserves. The allowance for possible loan and lease losses was \$9.3 million, or 1.6% of gross loans and leases, at June 30, 2010, compared to \$8.9 million, or 1.5%, at December 31, 2009. Net charge-offs through June 30, 2010 were \$1.1 million, resulting in an annualized net charge-off ratio of 0.4%.

A formal process is in place to enhance control over the underwriting of loans and to monitor loan collectability. This process includes education and training of personnel about the Bank's loan policies and procedures, assignment of credit analysts to support lenders, timely identification of loans with adverse characteristics, control of corrective actions and objective monitoring of loan reviews. The Special Assets Department of the Bank identifies and monitors assets that need special attention. At June 30, 2010, this process identified loans totaling \$10.6 million, or 1.9% of the portfolio, that were classified as other assets especially mentioned, compared to loans totaling \$8.7 million, or 1.5% of the portfolio, so classified at December 31, 2009. Loans totaling \$18.8 million, or 3.3% of the portfolio, were classified as substandard at June 30, 2010, compared to loans totaling \$25.5 million, or 4.4% of the portfolio, so classified at December 31, 2009. Loans totaling \$3.9 million, or 0.7% of the portfolio, were classified as doubtful at June 30, 2010, compared to no loans at December 31, 2009.



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**Deposits**

The Bank does not have any foreign offices and all deposits are serviced in its 17 domestic offices. The Bank's average deposits increased 4.3% during the first six months of 2010 compared to an increase of 7.0% in the first six months of 2009. Average total noninterest-bearing deposits were 15.1% of total deposits at June 30, 2010, contributing to the Bank's low cost of deposits, compared to 15.4% at December 31, 2009.

**Regulatory Requirements for Capital**

The Corporation and the Bank are subject to federal regulatory risk-adjusted capital adequacy standards. Failure to meet capital adequacy requirements could result in certain mandatory, and possibly additional discretionary, actions by regulators that could have a direct material adverse effect on the financial condition of the Corporation and the Bank. Federal regulations require the Corporation and the Bank to meet specific capital adequacy guidelines that involve quantitative measures of assets, liabilities and certain off-balance-sheet items as calculated under regulatory accounting practices. The capital classification is also subject to qualitative judgments by the regulators about components, risk weightings and other factors.

Under federal regulatory standards, to be well-capitalized, the Bank's Tier 1 Risk-Based Capital Ratio (ratio of Tier 1 Capital to risk-weighted assets) must be at least 6%, its Total Risk-Based Capital Ratio (ratio of total capital to risk-weighted assets) must be at least 10%, and its Tier 1 Leverage Capital Ratio (ratio of Tier 1 Capital to average assets) must be at least 5%. Equity capital (net of certain adjustments for intangible assets and investments in non-consolidated subsidiaries and certain classes of preferred stock) and other certain equity like instruments are considered Tier 1 Capital. Tier 2 Capital consists of core capital plus supplementary or temporary capital such as subordinated debt, some types of preferred stock, and a defined percentage of the allowance for possible loan and lease losses.

As of June 30, 2010, the Bank's Tier 1 Risk-Based Capital Ratio, Total Risk-Based Capital Ratio and Tier 1 Leverage Capital Ratios were 14.6%, 15.9%, and 10.1%, respectively, compared to 14.6%, 15.8%, and 10.2% at December 31, 2009. At June 30, 2010, the Corporation's Tier 1 Risk-Based Capital Ratio, Total Risk-Based Capital Ratio and Tier 1 Leverage Capital Ratios were 15.0%, 16.3% and 10.4%, respectively. The ratios were 14.9%, 16.2% and 10.5%, respectively, at December 31, 2009. Management believes, as of June 30, 2010, that the Corporation and the Bank each met all capital adequacy requirements to which they are subject.

**LIQUIDITY AND CAPITAL RESOURCES**

Most of the capital needs of the Bank historically have been financed with retained earnings and deposits received, and the Corporation's primary source of liquidity has been dividends declared by the Bank. In March 2008, the Bank obtained five advances at \$7 million each from the FHLB. The first two scheduled repayment of the advances were made in March 2009 and March 2010. The remaining payments will continue each March through 2013. In September 2008, the Bank obtained two additional advances of \$3.1 million each for a total borrowing in 2008 of \$41.2 million. The borrowings from the FHLB have been used generally for investment strategies to enhance the Bank's portfolio. Please refer to Note 5 in the notes to consolidated financial statements for additional information about borrowings from the FHLB and the repayment schedule of such borrowings.

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The Bank is subject to Tennessee statutes and regulations that impose restrictions on the amount of dividends that may be declared. Furthermore, any dividend payments are subject to the continuing ability of the Bank to maintain its compliance with minimum federal regulatory capital requirements and to retain its characterization under federal regulations as a well-capitalized institution. The Bank declared a \$0.37 per share dividend in the second quarter of 2010, which was paid in the third quarter of 2010. Management believes that the Corporation's traditional sources of cash generated from the Bank's operating activities are adequate to meet the Corporation's liquidity needs for normal ongoing operations. The Bank's Board of Directors has adopted a liquidity policy that outlines specific liquidity target balances. Compliance with this policy is reviewed quarterly by the Bank's Asset/Liability Committee and results are reported to the Bank's Board of Directors.

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The Bank's formal asset and liability management process is used to manage interest rate risk and assist management in maintaining reasonable stability in the gross interest margin as a result of changes in the level of interest rates and/or the spread relationships among interest rates. The Bank uses an earnings simulation model to evaluate the impact of different interest rate scenarios on the gross margin. Each quarter, the Bank's Asset/Liability Committee monitors the relationship of rate sensitive earning assets to rate sensitive interest-bearing liabilities (interest rate sensitivity), which is the principal factor in determining the effect that fluctuating interest rates will have on future net interest income. Rate sensitive earning assets and interest bearing liabilities are financial instruments that can be repriced to current market rates within a defined time period.

**CRITICAL ACCOUNTING POLICIES**

The accounting principles the Bank follows and the methods of applying these principles conform with accounting principles generally accepted in the United States and with general practices within the banking industry. In connection with the application of those principles, the Bank's management has made judgments and estimates that with respect to the determination of the ALLL and the recognition of deferred income tax assets, have been critical to the determination of the Corporation's financial position, results of operations and cash flows.

*Allowance for Loan and Lease Losses*

The Bank's management assesses the adequacy of the ALLL prior to the end of each month and prepares a more formal review quarterly to assess the risk in the Bank's loan portfolio. This assessment includes procedures to estimate the allowance and test the adequacy and appropriateness of the resulting balance. The ALLL represents calculated amounts for specifically identified credit exposure and exposures readily predictable by historical or comparative experience. Even though this calculation considers specific credits, the entire allowance is available to absorb any credit losses.

These calculated amounts are determined by assessing loans identified as not in compliance with loan agreements. These loans are generally in two different risk groups. One group is unique loans (commercial loans, including those loans considered impaired). The second group consists of pools of homogenous loans (generally retail and mortgage loans). The calculation for unique loans is based primarily on risk rating grades assigned to each of these loans as a result of the Bank's loan management and review processes. Each risk-rating grade is assigned a loss ratio, which is determined based on the experience of management, discussions with banking regulators and the independent loan review process. The amount allocated for an impaired loan is based on estimated cash flows discounted at the loan's original effective interest rate or the underlying collateral value. Historical data, including actual loss experience on specific types of homogenous loans, is used to allocate amounts for loans or groups of loans meeting the specified criteria. Management has implemented procedures that give more detailed historical data by category of retail and consumer credit and performance characteristics to broaden the analysis and improve monitoring of potential credit risk.

Criteria considered and processes utilized in evaluating the adequacy of the ALLL are:

- Portfolio quality trends;
- Changes in the nature and volume of the portfolio;
- Present and prospective economic and business conditions, locally and nationally;

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- Management review systems and board oversight, including external loan review processes;
- Changes in credit policy, credit administration, portfolio management and procedures;
- Changes in personnel, management and staff; and
- Existence and effect of any concentrations of credit.

In assessing the adequacy of the ALLL, the risk characteristics of the entire loan portfolio are evaluated. This process includes the judgment of the Bank's management, input from independent loan reviews and reviews that may have been conducted by bank regulators as part of their usual examination process.

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*Deferred Income Tax Assets*

As of June 30, 2010 and December 31, 2009, the deferred income tax asset was \$5.4 million and was included with other assets on the balance sheet. Deferred income tax assets consist mainly of the tax effect of excess provisions for loan and lease losses over actual losses incurred and deferred compensation. Management believes that it is more likely than not that these assets will be realized in future years.

**RESULTS OF OPERATIONS**

Total interest income for the first six months of 2010 was \$20.2 million compared to \$20.3 million for the first six months of 2009 and \$10.2 million for the three months ended June 30, 2010 compared to \$10.0 million for the three months ended June 30, 2009. Interest and fees earned on loans and investments are the components of total interest income. Interest and fees earned on loans were \$15.9 million, an increase of approximately \$155,000, or 1%, during the first six months of 2010 compared to the first six months of 2009 and \$8.1 million for the three months ended June 30, 2010, an increase of approximately \$148,000, or 1.9% compared to the three months ended June 30, 2009. Nominal interest earned on investment securities and other investments was \$4.3 million, a decrease of approximately \$254,000, or 5.6%, during the first six months of 2010 compared to the first six months of 2009 and \$2.1 million for the three months ended June 30, 2010, a decrease of approximately \$5,000, or 0.24%, compared to the three months ended June 30, 2009. The decrease in nominal interest earned on investment securities and other investments was primarily the result of market conditions.

Total interest expense in the first six months of 2010 was \$3.7 million, a decrease of \$1.2 million, or 24.7%, compared to the first six months of 2009 and \$1.8 million for the three months ended June 30, 2010, a decrease of approximately \$589,000 compared to the three months ended June 30, 2009. The lower interest rates for certificates of deposits and public funds during the second quarter of 2010 were the primary reason for the lower expense. As a policy, budgeted financial goals are monitored on a quarterly basis by the Bank's Asset/Liability Committee, which reviews the actual dollar change in net interest income for different interest rate movements. A negative dollar change in net interest income for a 12-month and 24-month period of less than 10.0% of net interest income given a 100 to 200 basis point shift in interest rates is considered an acceptable rate risk position. The rate risk analysis for the 24-month period beginning July 1, 2010 and ending June 30, 2012 showed a worst-case potential change to net interest income, in the very unlikely event of a down 100 bps in interest rates, of 4.4%, or a decrease in net interest income of \$1.4 million by the end of the period.

Net interest income of the Corporation on a fully taxable equivalent basis is influenced primarily by changes in:

- (1) the volume and mix of earning assets and sources of funding;
- (2) market rates of interest; and
- (3) income tax rates.

The impact of some of these factors can be controlled by management policies and actions. External factors also can have a significant impact on changes in net interest income from one period to another. Some examples of such factors are:

- (1) the strength of credit demands by customers;

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- (2) Federal Reserve Board monetary policy; and
- (3) fiscal and debt management policies of the federal government, including changes in tax laws.

The net interest margin, on a tax equivalent basis, at June 30, 2010, June 30, 2009 and December, 31, 2009 was 4.16%, 4.01% and 4.10%, respectively.

Additions of approximately \$405,000 were made to the provision for possible loan and lease losses in the second quarter of 2010 as a result of an increase in the level of credit losses on both secured and unsecured consumer loans as well as the Bank having to downgrade the credit level on a few commercial loans.

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Noninterest income was \$5.1 million, a decrease of \$2.5 million, or 32.9%, during the first six months of 2010 compared to the first six months of 2009 and a decrease of approximately \$929,000, or 28.9% during the three months ended June 30, 2010 compared to the three months ended June 30, 2009. The gains on sales of available-for-sale securities, which represented approximately \$502,000 in income during the first six months in 2010 and no gains in the three months ended June 30, 2010, compared to gains on sales of available-for-sale securities in the first six months of 2009, which represented approximately \$528,000 in the first six months of 2009, which represented \$2.4 million in the second quarter of 2009, were the primary reason for the variance in the first six months of 2010.

Noninterest expense, excluding the provision for possible loan and lease losses was \$16.9 million, an increase of approximately \$643,000, or 4.0%, in the first six months of 2010 as compared to the first six months of 2009 and a decrease of approximately \$31,000, or 0.4%, during the three months ended June 30, 2010 compared to the three months ended June 30, 2009. One of the reasons for the higher noninterest expense in the first six months was the increased expense to maintain other real estate. The Bank had approximately \$360,000 in the first six months of 2010, compared to only approximately \$35,000 in first six months of 2009.

The Corporation does not have any long-term debt or other long-term obligations; however, in 2008, the Bank received a \$41.2 million advance from the FHLB. The scheduled \$7.0 million annual principal maturities of borrowings under this credit line began in March 2009 and will end in 2013. Please refer to Note 5 in the notes to consolidated financial statements included in this report for additional information about borrowings from the FHLB.

The Bank also leases a certain number of its properties. There was no change during the three-month period ended June 30, 2010 in the terms of these leases.

Net income for the six months ended June 30, 2010 and the three months ended June 30, 2010 was \$3.1 million and \$1.9 million, respectively, compared to \$4.4 million and \$1.7 million for the six months ended June 30, 2009 and the three months ended June 30, 2009, respectively. An increase in operating expenses and losses on other real estate contributed to the six month decrease. The Corporation earned \$0.57 per share in the second quarter of 2010 and \$0.80 per share in the second quarter of 2009.

**OFF-BALANCE SHEET ARRANGEMENTS**

The Bank is a party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and stand-by letters of credit. These instruments involve, to varying degrees, elements of credit risk in excess of the amount recognized in the balance sheet. The contract or notional amounts of those instruments reflect the extent of involvement the Bank has in those financial instruments. Loan commitments are agreements to lend to a customer as long as there is not a violation of any condition established in the loan commitment contract. Stand-by letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. Those guarantees are primarily issued to support public and private borrowing arrangements, including commercial paper, bond financing and similar transactions. The credit risk involved in issuing letters of credit is essentially the same as that involved in making a loan.

The total outstanding balance of loan commitments and stand-by letters of credit in the normal course of business at June 30, 2010 were \$102.5 million and \$9.3 million, respectively, compared to \$108.3 million and \$9.5 million, respectively, at June 30, 2009.

At June 30, 2010, the Corporation and the Bank did not have any off-balance sheet arrangements other than commitments to extend credit and stand-by letters of credit.

**Item 3. Quantitative and Qualitative Disclosures About Market Risk.**

During the six months ended June 30, 2010, there were no material changes in the quantitative and qualitative disclosures about market risk presented in the Corporation's Annual Report on Form 10-K for the year ended December 31, 2009.

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**Item 4. Controls and Procedures.**

(a) Evaluation of Disclosure Controls and Procedures. The Corporation, with the participation of its management, including the Corporation's Chief Executive Officer and Assistant Treasurer (principal financial officer), carried out an evaluation of the effectiveness of the design and operation of its disclosure controls and procedures (as defined in Rules 13a-15 and 15d-15 under the Exchange Act) as of the end of the period covered by this report. Based upon that evaluation and as of the end of the period covered by this report, the Corporation's Chief Executive Officer and Assistant Treasurer (principal financial officer) concluded that the Corporation's disclosure controls and procedures were effective in ensuring that information required to be disclosed in its reports that the Corporation files or submits to the SEC under the Exchange Act is recorded, processed, summarized and reported on a timely basis.

(b) Changes in Internal Control Over Financial Reporting. There has been no change in the Corporation's internal control over financial reporting that occurred during the second quarter of 2010 that has materially affected, or is reasonably likely to materially affect, the Corporation's internal control over financial reporting.

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**PART II - OTHER INFORMATION**

**Item 1A. Risk Factors.**

Except as set forth below, there have been no material changes in the risk factors previously disclosed in the Corporation's Annual Report on Form 10-K for the year ended December 31, 2009.

*Recently enacted financial regulatory reforms could have a significant impact on our business, financial condition and results of operations.*

On July 21, 2010, the President signed the Dodd-Frank Wall Street Reform and Consumer Protection Act into law. The law includes, among other things:

- the creation of a Financial Services Oversight Council to identify emerging systemic risks and improve interagency cooperation;
- the elimination of the Office of Thrift Supervision and the transfer of oversight of federally chartered thrift institutions to the Office of the Comptroller of the Currency;
- the creation of a Consumer Financial Protection Agency authorized to promulgate and enforce consumer protection regulations relating to financial products, which would affect both banks and non-bank finance companies;
- the establishment of strengthened capital and prudential standards for banks and bank holding companies;
- enhanced regulation of financial markets, including derivatives and securitization markets;
- the elimination of certain trading activities from banks;
- a permanent increase of the previously implemented temporary increase of FDIC deposit insurance to \$250,000; and

- the creation of an Office of National Insurance within Treasury.

While the bill has been signed into law, a number of provisions of the law remain to be implemented through the rulemaking process at various regulatory agencies. Management is unable to predict what the final form of these rules will be when implemented by the respective agencies, but management believes that certain aspects of the new legislation, including, without limitation, the additional cost of higher deposit insurance and the costs of compliance with disclosure and reporting requirements and examinations by the new Consumer Financial Protection Agency, could have a significant impact on our business, financial condition and results of operations. Additionally, management cannot predict whether there will be additional proposed laws or reforms that would affect the U.S. financial system or financial institutions, whether or when such changes may be adopted, how such changes may be interpreted and enforced or how such changes may affect us.

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

The following table provides information regarding purchases of the Corporation's common stock made by the Corporation during the second quarter of 2010:

Table of Contents**CORPORATION'S PURCHASES OF EQUITY SECURITIES**

| <b>Period</b>                  | <b>Total<br/>Number of<br/>Shares<br/>Purchased</b> | <b>Average Price<br/>Paid per<br/>Share</b> | <b>Total Number of<br/>Shares Purchased<br/>as Part of Publicly<br/>Announced Plans<br/>or Programs</b> | <b>Maximum Number (or<br/>Approximate Dollar<br/>Value) of Shares that<br/>May Yet Be Purchased<br/>Under the Plans or<br/>Programs</b> |
|--------------------------------|---|---|---|---|
| April 1, 2010 - April 30, 2010 | 1,500*  | \$ 43.20                                    |   |   |
| May 1, 2010 - May 31, 2010     |   |   |   |   |
| June 1, 2010 - June 30, 2010   |   |   |   |   |
| <b>Total</b>                   | 1,500   | \$ 43.20                                    |   |   |

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\*Purchased from third-party sellers pursuant to previously negotiated agreements to purchase.

**Item 6. Exhibits.**

| <b>EXHIBIT<br/>NUMBER</b> | <b>DESCRIPTION</b>  |
|---------------------------|---|
| 3.1                       | Charter. (1)  |
| 3.2                       | Articles of Amendment to Charter. (1)   |
| 3.3                       | Second Amended and Restated By-laws. (2)  |
| 31.1                      | Certification of the Chief Executive Officer of First Farmers and Merchants Corporation Pursuant to Rule 13a-14 of the Securities Exchange Act of 1934, as amended, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.                           |
| 31.2                      | Certification of the Assistant Treasurer (principal financial officer) of First Farmers and Merchants Corporation Pursuant to Rule 13a-14 of the Securities Exchange Act of 1934, as amended, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 32.1                      | Certification of the Chief Executive Officer and Assistant Treasurer (principal financial officer) of First Farmers and Merchants Corporation Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.             |

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(1) Incorporated by reference from the First Farmers and Merchants Corporation Amendment No. 1 to the Annual Report on Form 10-K/A for the year ended December 31, 2003, as filed with the Securities and Exchange Commission on May 7, 2004 (File Number 000-10972).

(2) Incorporated by reference from the First Farmers and Merchants Corporation Current Report on Form 8-K, as filed with the Securities and Exchange Commission on December 21, 2009 (File Number 000-10972).



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**SIGNATURES**

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

FIRST FARMERS AND MERCHANTS CORPORATION

(Registrant)

Date August 5, 2010

/s/ T. Randy Stevens  
T. Randy Stevens, Chief Executive Officer

Date August 5, 2010

/s/ Patricia P. Bearden  
Patricia P. Bearden, Assistant Treasurer (principal financial officer and principal accounting officer)

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