FARMERS & MERCHANTS BANCORP
Form 10-K
March 13, 2013

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, 2012

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 x 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	Smaller Reporting Company o
		(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 o No x

The aggregate market value of the Registrant's common stock held by non-affiliates on June 30, 2012 (based on the last reported trade on June 29, 2012) was $292,102,000.

The number of shares of Common Stock outstanding as of February 28, 2013: 777,882

Documents Incorporated by Reference:
Portions of the definitive Proxy Statement for the 2013 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: (1) the response of federal and state regulators to changes in regional and national economic conditions; (2) the effect of the continuing recessionary-like conditions in our local markets, including the housing market in the Central Valley of California; (3) significant changes in interest rates and prepayment speeds; (4) credit risks of lending and investment activities; (5) changes in federal and state banking laws or regulations; (6) competitive pressure in the banking industry; (7) changes in governmental fiscal or monetary policies; (8) 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 (9) 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 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 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 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, 2012, consisted of 777,882 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 all of its daily operating and image advertising to the "F & M Bank" name and the Company's logo, slogan and signage were redesigned to incorporate the trade name, "F & M Bank."

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

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

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

As a bank holding company, the Company is subject to regulation and examination by the Board of Governors of the Federal Reserve System ("FRB"). The Bank is a California state-chartered non-FRB member bank subject to the regulation and examination of the California Department of 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 Metropolitan Statistical Area ("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 $42,000. The MSA includes significant employment in the following sectors: state and local government; agriculture; and trade, transportation and utilities. Unemployment currently stands at 10.6% and has increased 5.3% since 2007.

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 $33,000. The MSA includes significant employment in the following sectors: state and local government; agriculture; trade, transportation, and utilities; and education and health services. Unemployment currently stands at 15.2% and has increased 7.1% since 2007.

Modesto MSA, with branches in Modesto and Turlock. This MSA has a Population of 0.5 million and a Per Capita Income of approximately $33,000. 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 15.6% and has increased 6.9% since 2007.

Merced MSA with branches in Hilmar and Merced. This MSA has a Population of 0.3 million and a Per Capita Income of approximately $29,000. The MSA includes significant employment in the following sectors: agriculture; state and local government; and trade, transportation and utilities. Unemployment currently stands at 17.6% and has increased 7.5% since 2007.

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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, consumer, credit card, and real estate loans. Commercial products include term loans, lines of credit and other working capital financing and letters of credit. Financing products for individuals include automobile financing, lines of credit, residential real estate, home improvement and home equity lines of credit.

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

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

Employees

At December 31, 2012, the Company employed 299 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.

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 notice and/or approval of the FRB, may engage in any, or acquire shares of companies engaged in, activities that are deemed by the FRB to be so closely related to banking or managing or controlling banks as to be a proper incident thereto.

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

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

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

The Bank

The Bank, as a California chartered non-FRB member bank, is subject to primary supervision, periodic examination and regulation by the 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 $37.9 million at December 31, 2012.

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 or 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.”

The current risk-based capital guidelines which apply to the Bank are based upon the 1988 capital accord of international Basel Committee referred to as “Basel I.” A new international accord, referred to as Basel II evolved from 2004 to 2006 out of the efforts to revise capital adequacy standards for internationally active banks. In January 2009, the Basel Committee proposed to reconsider regulatory-capital standards, supervisory and risk-management requirements and additional disclosures to further strengthen the Basel II framework in response to recent worldwide economic developments referred to as “Basel III.”

On June 7, 2012, the FRB and FDIC issued proposed rules that would substantially amend the regulatory risk-based capital rules applicable to the Company and the Bank. The proposed rules implement the Basel III regulatory capital reforms and changes required by the Dodd-Frank Act (as hereinafter defined). The proposed rules indicated that the final rules would become effective on January 1, 2013, and the changes set forth in the final rules will be phased in from January 1, 2013 through January 1, 2019. However, the agencies have recently indicated that, due to the volume of public comments received, any final rule would be delayed past January 1, 2013.

Unlike previous proposed rules, the current proposed rule is applicable to all banking organizations that are currently subject to minimum capital requirements (including national banks, state member banks, state nonmember banks, state and federal savings associations, and top-tier bank holding companies domiciled in the United States not subject to the Board's Small Bank Holding Company Policy Statement), as well as top-tier savings and loan holding companies domiciled in the United States. Previous proposed rules were applicable to all U.S. bank holding companies with consolidated assets of $50 billion or more and any nonbank financial firms that may be designated as systemically important companies.

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The proposed rules include new minimum risk-based capital and leverage ratios, which would be phased in during 2013 and 2014, and would refine the definitions of what constitutes "capital" for purposes of calculating those ratios, including the proposed phase-out of trust preferred securities as qualifying regulatory capital. The proposed new minimum capital level requirements applicable to the Company and the Bank under the proposals would be: (i) a new common equity Tier 1 capital ratio of 4.5%; (ii) a Tier 1 capital ratio of 6% (increased from 4%); (iii) a total capital ratio of 8% (unchanged from current rules); and (iv) a Tier 1 leverage ratio of 4%. The proposed rules would also establish a "capital conservation buffer" of 2.5% above each of the new regulatory minimum capital ratios which would result in the following minimum ratios: (i) a common equity Tier 1 capital ratio of 7.0%, (ii) a Tier 1 capital ratio of 8.5%, and (iii) a total capital ratio of 10.5%. The new capital conservation buffer requirement would be phased in beginning in January 2016 at 0.625% of risk-weighted assets and would increase each year until fully implemented in January 2019. An institution would be subject to limitations on paying dividends, engaging in share repurchases, and paying discretionary bonuses if its capital level falls below the buffer amount. These limitations would establish a maximum percentage of eligible retained income that could be utilized for such actions. These proposed rules would also adjust the prompt corrective action categories accordingly.

The proposed rules also implement other revisions to the current capital rules such as recognition of all unrealized gains and losses on available for sale debt and equity securities, and provide that instruments that will no longer qualify as capital would be phased out over time.

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, 2012, 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.

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.

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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

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

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

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 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. Since December 2009, the Company has expensed $3,931,000 of this prepaid assessment. The remaining balance of the prepaid assessment was $3,327,000 at December 31, 2012.

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

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The Bank's FDIC premiums were $968,000 in 2012 compared to $1.5 million in 2011. Future increases in insurance premiums could have adverse effects on the operating expenses and results of operations of the Company. Management cannot predict what insurance assessment rates will be in the future.

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

Community Reinvestment Act ("CRA") and Fair Lending

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

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(Sarbanes-Oxley Act)

This legislation addresses certain accounting oversight and corporate governance matters, including but not limited to:

- required executive certification of financial presentations;
- increased requirements for board audit committees and their members;
- enhanced disclosure of controls and procedures and internal control over financial reporting;
- enhanced controls over, and reporting of, insider trading; and
- increased penalties for financial crimes and forfeiture of executive bonuses in certain circumstances.

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 Sarbanes-Oxley 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.

Consumer Protection Regulations

The Company's lending activities are subject to a variety of statutes and regulations designed to protect consumers, including the Fair Credit Reporting Act, Equal Credit Opportunity Act, the Fair Housing Act, and the Truth-in-Lending Act. Deposit operations are also subject to laws and regulations that protect consumer rights including Funds Availability, Truth in Savings, and Electronic Funds Transfers. Additional rules govern check writing ability on certain interest earning accounts and prescribe procedures for complying with administrative subpoenas of financial records. Additionally, a provision of the Federal Reserve Regulation E has been changed effective July 1, 2010 that puts restrictions on institutions assessing overdraft fees on consumer's accounts relating to debit card usage or other forms of transfers.

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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 made permanent with the passage of the Dodd-Frank Act); 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.

The Company decided not to participate in the TARP CPP.

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

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

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

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

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

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

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

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

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

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

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.

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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 10-K Report. The risks and uncertainties described below are not the only ones facing our business. Additional risks and uncertainties that management is not aware of or focused on or that management currently deems immaterial may also impair our business operations. This 10-K Report is qualified in its entirety by these risk factors.

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

Risks Associated With Our Business

Continuing Difficult Economic Conditions In Our Service Areas Could Adversely Affect Our Operations And/Or Cause Us To Sustain Losses - While the national economy and the economy of other portions of California have experienced recent improvements, the Central Valley of California, the Company's primary market area, continues to experience difficult economic and market conditions. 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 fully solved); and (2) significant private sector business failures and job 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 these areas and these areas continue to experience a significant deterioration in real estate values, foreclosures, and high unemployment and under-employment. 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 in our local areas. 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: 2013 and Beyond."

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

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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 in our local markets, we expect to continue to incur losses relating to 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 reduced 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.

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 other 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 Further Downturns In The Real Estate Market Could Hurt Our Business - Although our regulators have determined that we do not have significant CRE concentration risk, a significant portion of our loan portfolio is dependent on real estate. See "Item 1. Business – Supervision and Regulation - Prompt Corrective Action and Other Enforcement Mechanisms." At December 31, 2012, real estate served as the principal source of collateral with respect to approximately 73% of our loan outstandings and 22% of loans outstanding were secured by production agricultural properties. Continuing stresses in current economic conditions in our local markets or rising interest rates could have an adverse effect on the demand for new loans, the ability of borrowers to repay outstanding loans, the value of real estate and other collateral securing loans and the value of real estate owned by us, as well as our financial condition and results of operations in general and the market value of our common stock.

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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 the net interest margin. Like many financial institutions, our net interest margin has been declining. We expect that continued low interest rates and aggressive competitor pricing strategies will continue to push net interest margin lower in 2013.

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."

Continuing 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, and prepaying their existing loans. Under those circumstances, we would not be able to reinvest those prepayments in assets earning interest rates as high as the rates on the prepaid loans. In addition, our CRE and commercial loans, which carry interest rates that, in general, adjust in accordance with changes in the prime rate, will adjust to lower rates. We are also significantly affected by the level of loan 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: 2013 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;

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inability to control non-interest expense, including, but not limited to, rising employee and healthcare costs and the costs of regulatory compliance;

inability to maintain or increase non-interest income; and

continuing ability to expand through de novo branching or otherwise.

Our Financial Results Can Be Impacted By The Seasonality Of Our Agricultural Business And The Risks Related Thereto - The 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 2012 approximately 37% 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.

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.

Our Interest Expense May Increase Following The Repeal Of The Federal Prohibition On Payment Of Interest On Demand Deposits - The federal prohibition on the ability of financial institutions to pay interest on demand deposit accounts has been repealed. As a result, beginning on July 21, 2011, financial institutions could commence offering interest on demand deposits to compete for clients. Our interest expense will increase and our net interest margin will decrease if the Company begins offering interest on demand deposits to attract additional customers or maintain current customers, which could have a material adverse effect on our financial condition, net income and results of operations.

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.

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

Deposit Insurance Assessments Could Increase At Any Time, Which Will Adversely Affect Profits - FDIC deposit insurance expense for the years 2012, 2011, and 2010 was $968,000, $1.5 million, and $2.3 million, respectively. The FDIC has recently changed its methodology for calculating deposit premiums, See "Item 1. Business – Supervision and Regulation – Deposit Insurance." While FDIC deposit insurance assessments decreased in 2012, they remain well above the pre-recession level of $144,000 the Company paid in 2007, and additional increases could take place at any time due to continuing strains on the FDIC deposit insurance fund resulting from the cost of recent bank failures. Any increases could have adverse effects on the operating expenses and results of operations of the Company.

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

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

We rely heavily on communications and information systems to conduct our business. Any failure, interruption or breach in security of these systems could result in failures or disruptions in our customer relationship management, general ledger, deposit, loan 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.

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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 and we are subject to examination, supervision and comprehensive regulations by various regulatory agencies. Federal and state regulations are designed primarily to protect the deposit insurance funds and consumers, and not to benefit our stockholders. These regulations can sometimes impose significant limitations on our operations and increase our cost of doing business.

Further, federal monetary policy, particularly as implemented through the Federal Reserve System, significantly affects economic conditions for us.

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

Risks Associated With Our Stock

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

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

actual or anticipated variations in quarterly results of operations;

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

news reports relating to trends, concerns and other issues in the financial services industry;

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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 2013 and 2017. See Note 19 located in "Item 8. Financial Statements and Supplementary Data."

Item 3. Legal Proceedings

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

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

Item 4. Mine Safety Disclosures

Not Applicable

PART II

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

The common stock of Farmers & Merchants Bancorp is not widely held or listed on any exchange. However, trades may be reported on the OTC Bulletin Board under the symbol "FMCB." 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 2011. 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)
2012	Fourth quarter	$	405	$	355	$	405	$ 6.20
	Third quarter		375		355		375	-
	Second quarter		400		350		375	5.90
	First quarter		400		342		350	-

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	Calendar Quarter	High	Low	Close	Cash Dividends Declared (Per Share)
2011	Fourth quarter	$ 400	$ 345	$ 400	$ 6.10
	Third quarter	425	360	375	-
	Second quarter	410	383	410	5.65
	First quarter	425	400	400	-

As of January 31, 2013, there were approximately 1,480 stockholders of record of the Company's common stock.

The Company and, before the Company was formed, the Bank, have paid cash dividends for the past 78 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 common stock repurchase program. This program has been extended and expanded several times since then, and most recently, on September 11, 2012, the Board of Directors approved increasing the funds available for the Company's common stock repurchase program to $20 million over the three-year period ending September 30, 2015.

Repurchases under the program 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.

There were no shares repurchased by the Company during the fourth quarter of 2012. The approximate dollar value of shares that may yet be purchased under the program is $20 million.

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

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

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Performance Graphs

The following graph compares the Company's cumulative total stockholder return on common stock from December 31, 2007 to December 31, 2012 to that of: (i) the Morningstar Banks Index - Regional (US) Industry Group; and (ii) the cumulative total return of the New York Stock Exchange market index. The graph assumes an initial investment of $100 on December 31, 2007 and reinvestment of dividends. The stock price performance set forth in the following graph is not necessarily indicative of future price performance. The Company's stock price data is based on activity posted on the OTC Bulletin Board and on private transactions between individual stockholders that are reported to the Company. This data was furnished by Zacks SEC Compliance Services Group.

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

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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:	2012	2011	2010	2009	2008
Total Interest Income	$78,491	$82,354	$84,461	$91,314	$93,208
Total Interest Expense	5,140	7,974	9,685	16,331	24,784
Net Interest Income	73,351	74,380	74,776	74,983	68,424
Provision for Loan Losses	1,850	6,775	14,735	15,420	7,998
Net Interest Income After Provision for Loan Losses	71,501	67,605	60,041	59,563	60,426
Total Non-Interest Income	14,110	12,274	17,185	18,194	16,064
Total Non-Interest Expense	48,277	45,028	43,939	46,429	40,103
Income Before Income Taxes	37,334	34,851	33,287	31,328	36,387
Provision for Income Taxes	13,985	12,642	12,169	11,315	13,597
Net Income	$23,349	$22,209	$21,118	$20,013	$22,790
Balance Sheet Data:					
Total Assets	$1,974,686	$1,919,684	$1,841,491	$1,781,014	$1,684,437
Loans	1,246,902	1,163,078	1,176,002	1,212,718	1,177,364
Allowance for Loan Losses	34,217	33,017	32,261	29,813	20,034
Investment Securities	486,383	542,912	493,581	435,166	363,729
Deposits	1,722,026	1,626,197	1,566,503	1,498,124	1,432,702
Federal Home Loan Bank Advances	-	530	591	20,149	703
Shareholders' Equity	205,033	189,346	173,241	164,727	156,545
Selected Ratios:					
Return on Average Assets	1.22 %	1.19 %	1.19 %	1.15 %	1.44 %
Return on Average Equity	11.62 %	12.10 %	12.25 %	12.33 %	15.23 %
Dividend Payout Ratio	40.34 %	41.24 %	41.93 %	42.95 %	36.99 %
Average Loans to Average Deposits	72.02 %	74.48 %	79.03 %	80.12 %	84.16 %
Average Equity to Average Assets	10.45 %	9.85 %	9.74 %	9.34 %	9.46 %
Period-end Shareholders' Equity to Total Assets	10.38 %	9.86 %	9.41 %	9.25 %	9.29 %
Per Share Data:					
Net Income (1)	$29.99	$28.49	$27.05	$25.57	$28.69
Cash Dividends Per Share	$12.10	$11.75	$11.35	$11.00	$10.65

(1) Based on the weighted average number of shares outstanding of 778,648, 779,424, 780,619, 782,754, and 794,239 for the years ended December 31, 2012, 2011, 2010, 2009, and 2008, 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: 2008 through 2012
Through much of 2007 the economy in our primary service area was strong, the stock market rising and individuals and businesses doing well. Then in October 2007 the financial markets started what would become a major adjustment and an economic recession began that continues even today in the Central Valley of California. The Central Valley has been one of the hardest hit areas in the country during this recession. Housing prices in many areas declined as much as 60% and the economic stress eventually spread from residential real estate to other industry segments such as autos and commercial real estate. Unemployment levels remain above 15% in many areas.

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

(in thousands, except per share data)

Financial Performance Indicator	2012	2011	2010	2009	2008
Net Income	$ 23,349	$ 22,209	$ 21,118	$ 20,013	$ 22,790
Total Assets	$ 1,974,686	$ 1,919,684	$ 1,841,491	$ 1,781,014	$ 1,684,437
Total Loans	$ 1,246,902	$ 1,163,078	$ 1,176,002	$ 1,212,718	$ 1,177,364
Total Deposits	$ 1,722,026	$ 1,626,197	$ 1,566,503	$ 1,498,124	$ 1,432,702
Total Shareholders' Equity	$ 205,033	$ 189,346	$ 173,241	$ 164,727	$ 156,545
Total Consolidated Risk-Based Capital Ratio	14.96 %	14.86 %	13.82 %	12.48 %	12.59 %
Non-Performing Loans as a % of Total Loans	0.74 %	0.36 %	0.45 %	0.76 %	0.45 %
Substandard Loans as a % of Total Loans	1.72 %	3.67 %	3.40 %	5.17 %	3.01 %
Net Charge-Offs to Average Loans	0.05 %	0.51 %	1.04 %	0.48 %	0.57 %
Loan Loss Allowance as a % of Total Loans	2.74 %	2.83 %	2.74 %	2.45 %	1.70 %
Return on Average Assets	1.22 %	1.19 %	1.19 %	1.15 %	1.44 %
Return on Average Equity	11.62 %	12.10 %	12.25 %	12.33 %	15.23 %
Basic Earnings Per Common Share	$ 29.99	$ 28.49	$ 27.05	$ 25.57	$ 28.69
Cash Dividends Per Share	$ 12.10	$ 11.75	$ 11.35	$ 11.00	$ 10.65

Cash Dividends Declared	$ 9,418	$ 9,158	$ 8,855	$ 8,596	$ 8,430
# Shares Repurchased During Year	1,542	-	1,520	6,016	13,152
Average Share Price of Repurchased Shares	$ 373	$ -	$ 400	$ 387	$ 449
High Stock Price – Fourth Quarter	$ 405	$ 400	$ 425	$ 425	$ 450
Low Stock Price – Fourth Quarter	$ 355	$ 345	$ 400	$ 325	$ 385
Closing Stock Price – Fourth Quarter	$ 405	$ 400	$ 415	$ 380	$ 420

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Although the Company was not entirely immune to the pressures that a struggling economy brought to bear, management believes that the Company's performance compared very favorably to its peer banks during the five-year period ending December 31, 2012:

Net income totaled $109.5 million and never dropped below $20.0 million in any single year.

Return on Average Assets never dropped below 1.15% in any single year.

Total assets increased 29.9% to $1.97 billion.

Total loans increased 9.3% to $1.25 billion.

Total deposits increased 31.4% to $1.72 billion.

More recently:

In 2012, the Company earned $23.3 million for a return on average assets of 1.22%, and our return on average assets averaged 1.24% over the five-year period. Importantly, these strong results were generated at the same time the Company increased its loan loss allowance by $15.7 million, to $34.2 million or 2.74% of total loans.

In 2012, the Company increased its cash dividend per share by 3.0% over 2011 levels, and our strong financial performance allowed us to increase dividends every year during this five-year period, even as many banks eliminated or significantly reduced their dividends.

The Company's total risk based capital ratio was ––14.96% at December 31, 2012, and the Bank achieved the highest regulatory classification of "well capitalized" in each of the five years. See "Financial Condition – Capital."

Despite economic conditions in the Company's local markets, the Company's asset quality remains very strong compared to peer banks at the present time, when measured by: (1) net charge-offs of 0.52% of average loans during this five-year period; and (2) substandard loans totaling 1.72% of total loans at December 31, 2012. 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 24.7% since 2007, and totaled $56.85 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.

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Looking Forward: 2013 and Beyond

In management's opinion, the following key issues will influence the financial results of the Company in 2013 and future years:

The Company's earnings are heavily dependent on its net interest margin, which is sensitive to such factors as: (1) market interest rates; (2) the mix of our earning assets and interest bearing liabilities; and (3) competitor pricing strategies.

- During the third quarter of 2007, the FRB began dropping short-term market rates. Market rates remain low, and the FRB continues to imply that they expect them to remain that way well into 2014.
- Deposit growth continues to outstrip loan growth, and the Company's loan-to-deposit ratio has dropped every year since 2008. This results in an increasing percentage of our earning assets being placed into lower yielding investment securities, interest bearing deposits with banks, and Federal Funds Sold.
- Aggressive competitor pricing for both loans and deposits has often required the Company to respond in order to retain key customers.

The combination of these factors has caused the Company's net interest margin to decline from 4.89% in the second quarter of 2007 to 4.23% in the fourth quarter of 2012. The Company expects all of these factors to continue to push the net interest margin lower in 2013. See "Item 7A. Quantitative and Qualitative Disclosures About Market Risk - Interest Rate Risk."

The Company's results can be significantly influenced by changes in the credit quality of its borrowers. Substandard loans totaled $21.5 million or 1.72% of total loans at December 31, 2012 vs. $42.8 million or 3.67% of total loans at December 31, 2011, and a peak of $62.8 million or 5.17% of total loans at December 31, 2009. Management believes, based on information currently available, that these levels are adequately covered by the Company's $34.2 million allowance for loan losses as of December 31, 2012. 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 $1.9 million in 2012, a significant decrease from $6.8 million in 2011 and $14.7 million in 2010, but still remains above the pre-recession levels of $1.5 million in 2007. 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 expense for the years 2012, 2011, and 2010 was $968,000, $1.5 million, and $2.3 million, respectively. The FDIC has recently changed its methodology for calculating deposit premiums. See "Item 1. Business – Supervision and Regulation – Deposit Insurance." While FDIC deposit insurance assessments decreased in 2012, they remain well above the pre-recession level of $144,000 the Company paid in 2007, and additional increases could take place at any time due to continuing strains on the FDIC deposit insurance fund resulting from the cost of recent bank failures. Any increases could have adverse effects on the operating expenses and results of operations of the Company.

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

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, 2012, 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 2012, 2011, and 2010. 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, 2012		
Assets	Balance	Interest	Rate
Interest Bearing Deposits with Banks	$43,351	$110	0.25 %
Investment Securities:			
Government Agency & Government-Sponsored Entities	56,396	577	1.02 %
Municipals - Non-Taxable	70,432	4,047	5.75 %
Mortgage Backed Securities	399,121	9,182	2.30 %
Other	15,358	182	1.19 %
Total Investment Securities	541,307	13,988	2.58 %
Loans			
Real Estate	767,555	44,329	5.78 %
Home Equity	46,405	2,656	5.72 %
Agricultural	200,040	9,888	4.94 %
Commercial	163,089	8,455	5.18 %
Consumer	5,820	456	7.84 %
Other	237	13	5.49 %
Total Loans	1,183,146	65,797	5.56 %
Total Earning Assets	1,767,804	$79,895	4.52 %
Unrealized Gain on Securities Available-for-Sale	12,116		
Allowance for Loan Losses	(33,248)		
Cash and Due From Banks	33,941		
All Other Assets	140,998		
Total Assets	$1,921,611		
Liabilities & Shareholders' Equity			
Interest Bearing Deposits			
Interest Bearing DDA	$231,813	$167	0.07 %
Savings and Money Market	540,063	1,281	0.24 %
Time Deposits	496,327	2,291	0.46 %
Total Interest Bearing Deposits	1,268,203	3,739	0.29 %
Securities Sold Under Agreement to Repurchase	28,197	1,018	3.61 %
Other Borrowed Funds	3,698	36	0.97 %
Subordinated Debt	10,310	347	3.37 %
Total Interest Bearing Liabilities	1,310,408	$5,140	0.39 %
Interest Rate Spread			4.13 %
Demand Deposits	374,677		
All Other Liabilities	35,631		
Total Liabilities	1,720,716		
Shareholders' Equity	200,895		
Total Liabilities & Shareholders' Equity	$1,921,611		
Impact of Non-Interest Bearing Deposits and Other Liabilities			0.10 %
Net Interest Income and Margin on Total Earning Assets		74,755	4.23 %

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

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

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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, 2011			
Assets	Balance	Interest	Rate	
Interest Bearing Deposits with Banks	$46,694	$117	0.25	%
Investment Securities:				
Government Agency & Government-Sponsored Entities	201,666	2,292	1.14	%
Municipals - Non-Taxable	66,142	3,920	5.93	%
Mortgage Backed Securities	230,993	7,167	3.10	%
Other	2,593	31	1.20	%
Total Investment Securities	501,394	13,410	2.67	%
Loans				
Real Estate	720,402	45,146	6.27	%
Home Equity	54,964	3,198	5.82	%
Agricultural	215,001	12,013	5.59	%
Commercial	173,837	9,345	5.38	%
Consumer	7,338	465	6.34	%
Other	243	13	5.35	%
Total Loans	1,171,785	70,180	5.99	%
Total Earning Assets	1,719,873	$83,707	4.87	%
Unrealized Gain on Securities Available-for-Sale	5,172			
Allowance for Loan Losses	(32,651)			
Cash and Due From Banks	30,808			
All Other Assets	140,902			
Total Assets	$1,864,104			
Liabilities & Shareholders' Equity				
Interest Bearing Deposits				
Interest Bearing DDA	$206,572	$249	0.12	%
Savings and Money Market	488,540	1,586	0.32	%
Time Deposits	543,547	3,627	0.67	%
Total Interest Bearing Deposits	1,238,659	5,462	0.44	%
Securities Sold Under Agreement to Repurchase	60,000	2,148	3.58	%
Other Borrowed Funds	1,816	33	1.82	%
Subordinated Debt	10,310	330	3.20	%
Total Interest Bearing Liabilities	1,310,785	$7,973	0.61	%
Interest Rate Spread			4.26	%
Demand Deposits	334,698			
All Other Liabilities	35,085			
Total Liabilities	1,680,568			
Shareholders' Equity	183,536			
Total Liabilities & Shareholders' Equity	$1,864,104			
Impact of Non-Interest Bearing Deposits and Other Liabilities			0.14	%
Net Interest Income and Margin on Total Earning Assets		75,734	4.40	%

Tax Equivalent Adjustment	(1,354)	
Net Interest Income	$74,380	4.32 %

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 $2.3 million for the year ended December 31, 2011. 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, 2010		
Assets	Balance	Interest	Rate
Interest Bearing Deposits with Banks	$37,909	$91	0.24 %
Investment Securities:			
Government Agency & Government-Sponsored Entities	179,442	2,438	1.36 %
Municipals - Non-Taxable	70,403	4,202	5.97 %
Mortgage Backed Securities	156,162	6,456	4.13 %
Other	6,142	76	1.24 %
Total Investment Securities	412,149	13,172	3.20 %
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	9,277	469	5.06 %
Other	249	14	5.62 %
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 and Money Market	441,289	1,954	0.44 %
Time Deposits	575,516	4,992	0.87 %
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
Volume and Rate Analysis of Net Interest Revenue

(Interest and Rates on a Taxable Equivalent Basis) (in thousands)	2012 versus 2011 Amount of Increase (Decrease) Due to Change in:		
Interest Earning Assets	Volume	Rate	Net Chg.
Interest Bearing Deposits with Banks	$(8)	$1	$(7)
Investment Securities:			
Government Agency & Government-Sponsored Entities	(1,506)	(208)	(1,714)
Municipals - Non-Taxable	249	(123)	126
Mortgage Backed Securities	4,221	(2,206)	2,015
Other	151	-	151
Total Investment Securities	3,115	(2,537)	578
Loans:			
Real Estate	2,849	(3,666)	(817)
Home Equity	(491)	(51)	(542)
Agricultural	(800)	(1,325)	(2,125)
Commercial	(565)	(325)	(890)
Consumer	(107)	98	(9)
Total Loans	886	(5,269)	(4,383)
Total Earning Assets	3,993	(7,805)	(3,812)
Interest Bearing Liabilities			
Interest Bearing Deposits:			
Interest Bearing DDA	27	(109)	(82)
Savings and Money Market	154	(459)	(305)
Time Deposits	(294)	(1,042)	(1,336)
Total Interest Bearing Deposits	(113)	(1,610)	(1,723)
Securities Sold Under Agreement to Repurchase	(1,148)	18	(1,130)
Other Borrowed Funds	23	(20)	3
Subordinated Debt	-	17	17
Total Interest Bearing Liabilities	(1,238)	(1,595)	(2,833)
Total Change	$5,231	$(6,210)	$(979)

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)	2011 versus 2010 Amount of Increase (Decrease) Due to Change in:		
Interest Earning Assets	Volume	Rate	Net Chg.
Interest Bearing Deposits with Banks	$22	$4	$26
Investment Securities:			
Government Agency & Government-Sponsored Entities	281	(427)	(146)
Municipals - Non-Taxable	(253)	(29)	(282)
Mortgage Backed Securities	2,586	(1,875)	711
Other	(42)	(3)	(45)
Total Investment Securities	2,572	(2,334)	238
Loans:			
Real Estate	243	(535)	(292)
Home Equity	(469)	(44)	(513)
Agricultural	23	(837)	(814)
Commercial	(124)	(715)	(839)
Consumer	(109)	105	(4)
Other	-	(1)	(1)
Total Loans	(436)	(2,027)	(2,463)
Total Earning Assets	2,158	(4,357)	(2,199)
Interest Bearing Liabilities			
Interest Bearing Deposits:			
Interest Bearing DDA	38	(11)	27
Savings and Money Market	193	(561)	(368)
Time Deposits	(265)	(1,100)	(1,365)
Total Interest Bearing Deposits	(34)	(1,672)	(1,706)
Other Borrowed Funds	14	(17)	(3)
Subordinated Debt	-	(3)	(3)
Total Interest Bearing Liabilities	(20)	(1,692)	(1,712)
Total Change	$2,178	$(2,665)	$(487)

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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2012 Compared to 2011

Net interest income decreased 1.4% to $73.4 million during 2012. On a fully tax equivalent basis, net interest income decreased 1.3% and totaled $74.8 million during 2012 compared to $75.7 million for 2011. As more fully discussed below, the decrease in net interest income was primarily due to a decrease in the net interest margin, offset somewhat by growth 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 2012, the Company's net interest margin was 4.23% compared to 4.40% in 2011. This decrease in net interest margin was due primarily to: (1) a decline in the mix of loans as a percentage of total earning assets; and (2) declining yields on earning assets that exceeded a corresponding drop in funding costs.

Average loans totaled $1.2 billion for the year ended December 31, 2012, an increase of $11.4 million compared to the year ended December 31, 2011. Loans decreased from 68.1% of average earning assets during 2011 to 66.9% in 2012. As a result of the impact of decreases in market interest rates from mid-September 2007 through December 2008, and the continuing low rate environment since then, the year-to-date yield on the loan portfolio declined to 5.56% for the year ended December 31, 2012, compared to 5.99% for the year ended December 31, 2011. This lower yield offset the impact of an increase in average loan balances resulting in interest revenue from loans decreasing 6.3% to $65.8 million for 2012. 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. Historically, the Company invested primarily in: (1) mortgage-backed securities issued by government-sponsored entities; (2) debt securities issued by government agencies and government-sponsored entities; and (3) investment grade bank-qualified municipal bonds. However, during 2012, the Company began to selectively add corporate securities to the portfolio. Since the risk factor for these types of investments is generally 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 $39.9 million in 2012 compared to the average balance during 2011. As a result, tax equivalent interest income on securities increased $578,000 to $14.0 million for the year ended December 31, 2012, compared to $13.4 million for the year ended December 31, 2011. The average yield, on a tax equivalent basis, in the investment portfolio was 2.6% in 2012 compared to 2.7% in 2011. This decrease in yield was caused by a significant decline in the yield on the Company's mortgage-backed securities portfolio due to: (1) a shift in mix from 30 year MBS to 10, 15 and 20 year MBS; (2) a decline in overall mortgage rates; and (3) increased prepayment speeds on MBS purchased at a premium requiring those premiums to be amortized over a shorter period. This decline was partially offset by a shift in mix from short-term government agencies securities into mortgage-back securities and corporate securities See "Financial Condition – Investment Securities" for a discussion of the Company's investment strategy in 2012. Net interest income on the Schedule of Year-to-Date Average Balances and Interest Rates is shown on a tax equivalent basis, which is higher than net interest income as reflected on the Consolidated Statements of Income because of adjustments that relate to income on securities that are exempt from federal income taxes.

Interest bearing deposits with banks and overnight investments in Federal Funds Sold are additional earning assets available to the Company. Average interest bearing deposits with banks consisted of: (1) $149,000 in Community Reinvestment Act ('CRA') qualified CD's with various banks; and (2) $43.2 million in FRB deposits. The FRB currently pays interest on the deposits that banks maintain in their FRB account, whereas historically banks had to sell these Federal Funds to other banks in order to earn interest. Since balances at the FRB are effectively risk free, the Company elected to maintain its excess cash at the FRB during 2012 and 2011. These balances earn interest at the Fed

Funds rate, which has been 0.25% since December, 2008. Total average interest bearing deposits with banks for the year ended December 31, 2012 was $43.4 million, a decrease of $3.3 million from the average balance for the year ended December 31, 2011. The Company had no Federal Funds Sold during 2012 or 2011.

Average interest-bearing liabilities decreased $377,000 or 0.03% during the twelve months ended December 31, 2012. Of that decrease: (1) interest-bearing deposits increased $29.5 million; (2) FHLB Advances increased $1.9 million; and (3) securities sold under agreement to repurchase and subordinated debt decreased $31.8 million.

The $29.5 million increase in average interest-bearing deposits was primarily in lower cost interest bearing DDA, and savings and money market deposits, which increased $76.7 million since 2011, as higher cost time deposits decreased by $47.2 million. See "Financial Condition – Deposits" for a discussion of trends in the Company's deposit base. Total interest expense on deposits was $3.7 million for 2012 as compared to $5.5 million for 2011. The average rate paid on interest-bearing deposits was 0.29% in 2012 and 0.44% in 2011. 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 future declines in deposit rates, if any, will be much more modest. See "Overview – Looking Forward: 2013 and Beyond" for a discussion of factors impacting the Company's future deposit rates and their impact on net interest margin.

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

2011 Compared to 2010

Net interest income decreased 0.53% to $74.4 million during 2011. On a fully tax equivalent basis, net interest income decreased 0.64% and totaled $75.7 million during 2011 compared to $76.2 million for 2010. As more fully discussed below, the decrease in net interest income was primarily due to a decrease in the net interest margin, offset somewhat by growth 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 2011, the Company's net interest margin was 4.40% compared to 4.68% in 2010. This decrease in net interest margin was due primarily to a decrease in loans as a percentage of total earning assets combined with lower yields on earning assets.

Average loans totaled $1.2 billion for the year ended December 31, 2011, an increase of $7.9 million compared to the year ended December 31, 2010. Loans decreased from 72.4% of average earning assets during 2010 to 68.1% in 2011. As a result of the impact of decreases in market interest rates from mid-September 2007 through December 2008, and the continuing low rate environment since then, the year-to-date yield on the loan portfolio declined to 5.99% for the year ended December 31, 2011, compared to 6.16% for the year ended December 31, 2010. The decrease in loan balances combined with the lower yield resulted in interest revenue from loans decreasing 3.4% to $70.2 million for 2011. 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: (1) mortgage-backed securities issued by government-sponsored entities; (2) debt securities issued by government agencies and government-sponsored entities; and (3) investment grade bank-qualified municipal bonds. 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 $89.2 million in 2011 compared to the average balance during 2010. As a result, tax equivalent interest income on securities increased $238,000 to $13.4 million for the year ended December 31, 2011, compared to $13.2 million for the year ended December 31, 2010. The average yield, on a tax equivalent basis, in the investment portfolio was 2.7% in 2011 compared to 3.2% in 2010. This decrease in yield was primarily due to: (1) the sale of higher yielding mortgage-backed securities in early 2010; and (2) a decline in market interest rates. 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.

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Interest bearing deposits with banks and overnight investments in Federal Funds Sold are additional earning assets available to the Company. The FRB currently pays interest on the deposits that banks maintain in their FRB account, whereas historically banks had to sell these Federal Funds to other banks in order to earn interest. Since balances at the FRB are effectively risk free, the Company elected to maintain its excess cash at the FRB during 2011 and 2010. These balances earn interest at the Fed Funds rate, which has been 0.25% since December, 2008. Average interest bearing deposits with banks for the year ended December 31, 2011 was $46.7 million, an increase of $8.8 million from the average balance for the year ended December 31, 2010.

Average interest-bearing liabilities increased $47.7 million or 3.8% during the twelve months ended December 31, 2011. Of that increase: (1) interest-bearing deposits increased $47.1 million; (2) FHLB Advances increased $593,000; and (3) securities sold under agreement to repurchase and subordinated debt remained unchanged.

The $47.1 million increase in average interest-bearing deposits was primarily in lower cost interest bearing DDA, and savings and money market deposits, which increased $79.1 million since 2010, as higher cost time deposits decreased by $32.0 million. Total interest expense on deposits was $5.5 million for 2011 as compared to $7.2 million for 2010. As a result of the impact of decreases in market interest rates from mid September 2007 through December 2008, and the continuing low rate environment since then. The average rate paid on interest-bearing deposits was 0.44% in 2011 and 0.60% in 2010. 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 2012.

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 subject to more stringent reporting and oversight.

Allowance for Loan Losses

The allowance for loan losses is an estimate of probable incurred 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 collectively evaluated for impairment.

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.

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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 and historical performance of the restructured credit.

The determination of the general reserve for loans that are collectively evaluated for impairment is based on estimates made by management, to include, but not limited to, consideration of historical losses by portfolio segment, internal asset classifications, and qualitative factors 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 & other. 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.

The Company assigns a risk rating to all loans 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. A credit grade is established at inception for smaller balance loans, such as consumer and residential real estate, and then updated only when the loan becomes contractually delinquent or when the borrower requests a modification. 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, based on 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.

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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 2011. 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 declined as much as 60% and the economic stress eventually spread from residential real estate to other industry segments such as autos and commercial real estate. Unemployment levels remain above 15% in many areas. Accordingly, over the past several years, management and the Board of Directors have increased the Company's loan loss allowance and as of December 31, 2012, the balance was $34.2 million or 2.74% of total loans. This represents a $1.2 million or 3.6% increase over December 31, 2011. Although, in management's opinion, the Company's levels of net charge-offs and non-performing assets as of December 31, 2012, 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.

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The provision for loan losses totaled $1.9 million in 2012 compared to $6.8 million in 2011 and $14.7 million in 2010. Net charge-offs during 2012 were $650,000 compared to $6.0 million in 2011 and $12.3 million in 2010. Net charge-offs represented 0.05% of average loans during 2012, a level that in management's opinion compares very favorably to the Company's peers at the present time. The reduction in the provision over the prior two years reflects management's assessment of the overall adequacy of the allowance as well as the reduction in net charge offs in 2012 compared to 2011 and 2010. See "Overview – Looking Forward: 2013 and Beyond," "Critical Accounting Policies and Estimates – Allowance for Loan Losses" and "Item 7A. Quantitative and Qualitative Disclosures About Market Risk-Credit Risk." The following tables summarize the activity and the allocation of the allowance for losses for the years indicated. (in thousands)

	2012	2011	2010	2009	2008
Allowance for Loan Losses Beginning of Year	$33,017	$32,261	$29,813	$20,034	$18,483
Provision Charged to Expense	1,850	6,775	14,735	15,420	7,998
Charge Offs:					
Commercial Real Estate	-	25	1,629	-	-
Agricultural Real Estate	-	384	559	-	-
Real Estate Construction	-	-	4,095	641	4,648
Residential 1st Mortgages	152	449	759	749	192
Home Equity Lines and Loans	259	751	310	391	-
Agricultural	294	3,559	916	123	209
Commercial	198	788	4,143	3,868	1,405
Consumer & Other	145	190	112	159	323
Total Charge Offs	1,048	6,146	12,523	5,931	6,777
Recoveries:					
Commercial Real Estate	-	-	-	-	-
Agricultural Real Estate	90	18	2	-	-
Real Estate Construction	-	-	-	-	-
Residential 1st Mortgages	53	4	7	3	-
Home Equity Lines and Loans	14	13	-	1	-
Agricultural	61	10	68	50	60
Commercial	117	21	92	104	143
Consumer & Other	63	61	67	132	127
Total Recoveries	398	127	236	290	330
Net Charge-Offs	(650)	(6,019)	(12,287)	(5,641)	(6,447)
Total Allowance for Loan Losses	$34,217	$33,017	$32,261	$29,813	$20,034
Ratios:					
Allowance for Loan Losses to:					
Total Loans at Year End	2.74%	2.83%	2.74%	2.45%	1.70%
Average Loans	2.89%	2.82%	2.73%	2.52%	1.77%
Consolidated Net Charge-Offs to:					
Loans at Year End	0.05%	0.52%	1.04%	0.46%	0.55%
Average Loans	0.05%	0.51%	1.04%	0.48%	0.57%

December 31, 2012	Commercial Real Estate	Agricultural Real Estate	Real Estate Construction	Residential 1st Mortgages	Home Equity Lines & Loans	Agricultural	Commercial	Consumer & Other	Unallocated	Total

Year-To-Date Allowance for Credit Losses:										
Beginning Balance-January 1, 2012	$ 5,823	$ 2,583	$ 1,933	$ 1,251	$ 3,746	$ 8,127	$ 8,733	$ 207	$ 614	$ 33,017
Charge-Offs	-	-	-	(152)	(259)	(294)	(198)	(145)	-	(1,048)
Recoveries	-	90	-	53	14	61	117	63	-	398
Provision	641	204	(947)	67	(266)	2,543	(689)	57	240	1,850
Ending Balance-December 31, 2012	$ 6,464	$ 2,877	$ 986	$ 1,219	$ 3,235	$ 10,437	$ 7,963	$ 182	$ 854	$ 34,217

The provision of $2.5 million in Agricultural loans was primarily a result of the impact that drought conditions in many areas of the country are having on the feed prices of our dairy customers. See “Management’s Discussion and Analysis - Financial Conditions – Classified Loans and Non-Performing Assets.”

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	Allowance Allocation at December 31,									
(in thousands)	2012 Amount	Percent of Loans in Each Category to Total Loans	2011 Amount	Percent of Loans in Each Category to Total Loans	2010 Amount	Percent of Loans in Each Category to Total Loans	2009 Amount	Percent of Loans in Each Category to Total Loans	2008 Amount	Percent of Loans in Each Category to Total Loans
Commercial Real Estate	$6,464	28.2 %	$5,823	26.4 %	$7,631	27.0 %	$12,845	23.9 %	$3,547	23.0 %
Agricultural Real Estate	2,877	25.0 %	2,583	24.0 %	1,539	21.6 %	1,099	21.4 %	1,683	19.3 %
Real Estate Construction	986	2.6 %	1,933	2.5 %	2,160	3.2 %	4,089	5.9 %	1,514	6.4 %
Residential 1st Mortgages	1,219	11.2 %	1,251	9.2 %	1,164	8.8 %	552	8.7 %	992	9.0 %
Home Equity Lines and Loans	3,235	3.4 %	3,746	4.4 %	3,724	5.0 %	1,349	5.4 %	1,781	5.6 %
Agricultural	10,437	17.7 %	8,127	18.6 %	6,733	19.6 %	2,298	17.9 %	4,432	18.4 %
Commercial	7,963	11.5 %	8,733	14.2 %	9,084	14.0 %	6,449	15.8 %	4,933	17.2 %
Consumer & Other	182	0.4 %	207	0.7 %	216	0.8 %	325	1.0 %	926	1.1 %
Unallocated	854		614		10		807		226	
Total	$34,217	100.0 %	$33,017	100.0 %	$32,261	100.0 %	$29,813	100.0 %	$20,034	100.0 %

As of December 31, 2012, the allowance for loan losses was $34.2 million, which represented 2.74% of the total loan balance. At December 31, 2011, the allowance for loan losses was $33.0 million or 2.83% 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, 2012, was adequate.

Non-Interest Income

Non-interest income includes: (1) service charges and fees from deposit accounts; (2) net gains and losses from investment securities; (3) increases in the cash surrender value of bank owned life insurance; (4) debit card and ATM fees; (5) net gains and losses on non-qualified deferred compensation plan investments; and (6) fees from other miscellaneous business services. See "Overview – Looking Forward: 2013 and Beyond."

2012 Compared to 2011

Non-interest income totaled $14.1 million, an increase of $1.8 million or 15.0% from non-interest income of $12.3 million for 2011.

Service charges on deposit accounts totaled $4.9 million, a decrease of $504,000 or 9.3% from service charges on deposit accounts of $5.4 million in 2011. This was due primarily to a decrease in fees related to the Company's Overdraft Privilege Service.

Net gain on investment securities was $158,000 in 2012 compared to a net gain of $95,000 for 2011. See "Financial Condition-Investment Securities" for a discussion of the Company's investment strategy.

Debit Card and ATM fees totaled $2.9 million, an increase of $178,000 or 6.5% over fees in 2011. 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 cards to complete purchases.

Net Gains on deferred compensation investments were $1.7 million in 2012 compared to net gains of $199,000 in 2011. See Note 16. located in "Item 8. Financial Statements and Supplementary Data" for a description of these plans. Balances in non-qualified deferred compensation plans may be invested in financial instruments whose market value fluctuates based upon trends in interest rates and stock prices. Although Generally Accepted Accounting Principles require these investment gains/losses be recorded in non-interest income, an offsetting entry is also required to be made to non-interest expense resulting in no effect on the Company's net income.

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Other non-interest income was $2.6 million, an increase of $609,000 or 30.6% over 2011. This was primarily due to SWAP referral fees paid to F&M Bank. Swap fee income results from the Bank arranging for a borrower to enter into a swap directly with a counterparty. These transactions result in both the Bank and the borrower achieving their interest rate risk management objectives without requiring the Bank to assume the hedge accounting or mark-to-market risk exposure of a swap. Whereas the Bank may still need to provide certain credit guarantees to the counterparty, if the loan is appropriately “over-collateralized,” that credit risk can be mitigated or eliminated. This service began in the fourth quarter of 2011.

2011 Compared to 2010

Non-interest income totaled $12.3 million, a decrease of $4.9 million or 28.6% from non-interest income of $17.2 million for 2010.

Service charges on deposit accounts totaled $5.4 million, a decrease of $1.1 million or 17.4% from service charges on deposit accounts of $6.5 million in 2010. This was due primarily to a decrease in fees related to the Company’s Overdraft Privilege Service.

Net gain on investment securities was $95,000 in 2011 compared to a net gain of $2.9 million for 2010.

Debit Card and ATM fees totaled $2.8 million, an increase of $169,000 or 6.5% over fees in 2010. 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.

Net Gains on deferred compensation investments were $199,000 in 2011 compared to net gains of $1.4 million in 2010.

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.

2012 Compared to 2011

Overall, non-interest expense totaled $48.3 million, an increase of $3.2 million or 7.2% for the year ended December 31, 2012.

Salaries and employee benefits increased $2.0 million or 6.6% primarily related to increases in salary and medical insurance premiums.

Net Gains on deferred compensation investments were $1.7 million in 2012 compared to net gains of $199,000 in 2011. See Note 16. located in “Item 8. Financial Statements and Supplementary Data” for a description of these plans. Balances in non-qualified deferred compensation plans may be invested in financial instruments whose market value fluctuates based upon trends in interest rates and stock prices. Although Generally Accepted Accounting Principles require these investment gains/losses be recorded in non-interest expense, an offsetting entry is also required to be made to non-interest income resulting in no effect on the Company’s net income.

Equipment expense in 2012 totaled $3.1 million, an increase of $284,000 or 10.0% from 2011. This increase is due to increases in software maintenance contracts and Americans with Disabilities Act (‘ADA’) upgrades to all of our ATM machines.

ORE holding costs in 2012 totaled $122,000, a decrease of $1.7 million or 93.2% as compared to $1.8 million in 2011. This decrease is primarily due to a decrease in the number of ORE properties the Company owns and stabilization of real estate values.

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The Company's total FDIC insurance costs decreased $493,000 in 2012 to $968,000, a 33.7% decrease from $1.5 million in 2011. The FDIC changed to a new methodology for determining assessment rates in second quarter 2011. See "Supervision and Regulation – Deposit Insurance" for further discussion of the Company's deposit insurance.

Legal fee expense increased $163,000 or 18.6% from 2011. This increase is primarily related to the management and collection of our problem loans.

On June 21, 2012, the Company terminated both repurchase agreements with Citigroup resulting in an early termination fee totaling $1.7 million. The Company determined that the time was appropriate to replace these relatively "high-cost" borrowings with short-term FHLB advances at substantially lower rates. This rate differential will positively impact the Company's net interest margin over the next 6-9 months, the period during which the repurchase agreements were scheduled to mature.

Other non-interest expense decreased $138,000, or 2.5%, to $5.5 million in 2012 compared to $5.6 million in 2011. This decrease was primarily due to the write-off of other repossessed assets in the amount of $271,000, which took place in 2011. Only $20,000 was written-off in 2012.

2011 Compared to 2010

Overall, non-interest expense totaled $45.0 million, an increase of $1.1 million or 2.5% for the year ended December 31, 2011.

Salaries and employee benefits increased $1.3 million or 4.7% primarily related to salary increases for officers that took place in April, 2011.

Net Gains on deferred compensation investments were $199,000 in 2011 compared to net gains of $1.4 million in 2010. Balances in non-qualified deferred compensation plans may be invested in financial instruments whose market value fluctuates based upon trends in interest rates and stock prices. Although Generally Accepted Accounting Principles require these investment gains/losses be recorded in non-interest expense, an offsetting entry is also required to be made to non-interest income resulting in no effect on the Company's net income.

Occupancy expense in 2011 totaled $2.6 million, an increase of $157,000 or 6.5% from 2010. This increase was due to adjustments to the property tax accruals.

Equipment expense in 2011 totaled $2.8 million, an increase of $239,000 or 9.2% from 2010. This increase is due to increases in software maintenance contracts.

ORE holding costs in 2011 totaled $1.8 million, an increase of $538,000 or 43.1% as compared to $1.2 million in 2010. This increase is primarily due to an increase in the required reserve for ORE valuation adjustments.

The Company's total FDIC insurance costs decreased $825,000 in 2011 to $1.5 million, a 36.1% decrease from $2.3 million in 2010. The FDIC changed to a new methodology for determining assessment rates in second quarter 2011.

Legal fee expense increased $476,000 or 119.0% from 2010. This increase is primarily related to the management and collection of our problem loans.

Other non-interest expense increased $343,000, or 6.5%, to $5.6 million in 2011 compared to $5.3 million in 2010. This increase was primarily due to losses on sale of ORE properties that amounted to $471,000. This increase was partially offset by decreased ORE property tax expense due to the sale of some ORE properties.

Income Taxes

The provision for income taxes increased $1.3 million during 2012. The effective tax rate in 2012 was 37.5% compared to 36.3% in 2011 and 36.6% in 2010. 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.

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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.

Financial Condition

Investment Securities and Federal Funds Sold

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: (1) mortgage-backed securities issued by federal government-sponsored entities; (2) debt securities issued by government agencies and government-sponsored entities; and (3) investment grade bank-qualified municipal bonds. However, during 2012, the Company began to selectively add investment grade corporate securities (floating rate and fixed rate with maturities less than 5 years) to the portfolio in order to obtain yields that exceed government agency securities of equivalent maturity without subjecting the Company to the interest rate risk associated with mortgage-backed securities. 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 2012 was $486.4 million, a decrease of $56.5 million or 10.4% from 2011. The mix of the investment portfolio has changed over the past three years. To protect against future increases in market interest rates, while at the same time generating some reasonable level of current yields, the Company invested most of its available funds of the past three years in shorter term government agency & government-sponsored entity securities and shorter term (10, 15, and 20 year) mortgage-backed securities. Beginning in mid-2012 the Company began to reduce its investment in mortgage-backed securities in order to reduce the risk associated with fixed rate term assets purchased at a premium. Excess cash was placed into corporate securities or left on deposit with the FRB.

As of December 31, 2012, the Company held $71.4 million of municipal investments, of which $57.9 million were bank-qualified municipal bonds, all classified as held-to-maturity. The continuing financial problems being experienced by certain municipalities, along with the financial stresses exhibited by some of the large monoline bond insurers, have increased the overall risk associated with bank-qualified municipal bonds. This situation caused the Company not to purchase any municipal bonds between late 2006 and year-end 2011. However, during 2012 the Company began investing in bank-qualified investment grade municipals. As of December 31, 2012 ninety-three percent of the Company's bank-qualified municipal bond portfolio is rated at either the issue or issuer level, and all of these ratings are "investment grade." Additionally, in order to comply with Section 939A of the Dodd-Frank Act, the Company performs its own credit analysis on new purchases of municipal bonds and corporate securities. The Company monitors the status of the approximately seven percent ($3.8 million) of the portfolio that is not rated and at the current time does not believe any of them to be exhibiting financial problems that could result in a loss in any individual security.

Not included in the investment portfolio are interest bearing deposits with banks and overnight investments in Federal Funds Sold. Average interest bearing deposits with banks consisted of: (1) $149,000 in Community Reinvestment Act ('CRA') qualified CD's with various banks; and (2) $43.2 million in FRB deposits. The FRB currently pays interest on the deposits that banks maintain in their FRB account, whereas historically banks had to sell these Federal Funds to other banks in order to earn interest. Since balances at the FRB are effectively risk free, the Company elected to maintain its excess cash at the FRB during 2012 and 2011. These balances earn interest at the Fed Funds rate, which has been 0.25% since December, 2008. Total average interest bearing deposits with banks for the year ended December 31, 2012 was $43.4 million, a decrease of $3.3 million from the average balance of $46.7 million for the year ended December 31, 2011. The Company had no Federal Funds Sold during 2012 or 2011.

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, 2012 and 2011, 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.

	Available for Sale	Held to Maturity	Available for Sale	Held to Maturity	Available for Sale	Held to Maturity
December 31: (in thousands)	2012		2011		2010	
Government Agency & Government Sponsored Entities	$26,823	$-	$82,595	$-	$236,319	$-
Municipal	5,665	65,694	5,782	59,640	6,378	60,439
Mortgage Backed Securities	352,772	484	391,033	1,205	185,637	2,218
Corporate Securities	22,558	-	-	-	-	-
Other	10,173	2,214	410	2,247	310	2,280
Total Book Value	$417,991	$68,392	$479,820	$63,092	$428,644	$64,937
Fair Value	$417,991	$70,697	$479,820	$65,874	$428,644	$66,039

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, 2012. Non-taxable municipal securities have been calculated on a fully taxable equivalent basis.

December 31, 2012 (in thousands)	Fair Value	Average Yield	
Government Agency & Government Sponsored Entities			
After one year through five years	$25,617	0.73	%
After five years through ten years	1,206	2.78	%
Total Government Agency & Government Sponsored Entities	26,823	0.82	%
Municipal - Non-Taxable			
After five years through ten years	217	5.47	%
After ten years	5,448	7.61	%
Total Non-Taxable Municipal Securities	5,665	7.53	%
Mortgage Backed Securities			
After one year through five years	339	4.61	%
After five years through ten years	107,227	2.10	%
After ten years	245,206	2.24	%
Total Mortgage Backed Securities	352,772	2.20	%
Corporate Securities - Taxable			
One year or less	1,001	2.30	%
After one year through five years	20,303	1.74	%
After five years through ten years	1,254	1.80	%
Total Taxable Corporate Securities	22,558	1.77	%
Other			
One year or less	10,173	0.38	%
Total Other Securities	10,173	0.38	%
Total Investment Securities Available-for-Sale	$417,991	2.11	%

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, 2012. Non-taxable municipal securities have been calculated on a fully taxable equivalent basis.

December 31, 2012 (in thousands)	Book Value	Average Yield	
Municipal - Non-Taxable			
One year or less	$1,805	5.31	%
After one year through five years	11,200	5.88	%
After five years through ten years	37,373	6.00	%
After ten years	15,316	4.13	%
Total Non-Taxable Municipal Securities	65,694	5.52	%
Mortgage Backed Securities			
After one year through five years	484	3.68	%
Total Mortgage-Backed Securities	484	3.68	%
Other			
After one year through five years	5	4.23	%
After five years through ten years	2,209	0.95	%
Total Other Securities	2,214	0.96	%
Total Investment Securities Held-to-Maturity	$68,392	5.36	%

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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 Loan To Value (LTV) below 75%; and where the property can be developed and sold within 2 years. Commercial construction loans are made only when there is a written take-out commitment from the Bank or an acceptable financial institution or government agency. Most acquisition, development and construction loans are tied to the prime rate with an appropriate spread based on the amount of perceived risk in the loan.

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

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

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

Each loan type involves risks specific to the: (1) borrower; (2) collateral; and (3) 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: (1) on both a fixed rate and adjustable rate basis; (2) over different terms; and (3) based upon different rate indices; as long as these structures are consistent with the Company's interest rate risk management policies and procedures. See "Item 7A. Quantitative and Qualitative Disclosures About Market Risk-Interest Rate Risk."

Overall, the Company's loan portfolio at December 31, 2012, increased $83.8 million or 7.2% from December 31, 2011. These increases have occurred despite what has been a difficult economic environment combined with a very competitive pricing environment, and are a result of the Company's intensified business development efforts directed toward credit-qualified borrowers. No assurances can be made that this growth in the loan portfolio will continue until the economy in the Central Valley of California improves.

Beginning in late 2006, 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.

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

	2012		2011		2010		2009		2008	
	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percen
Commercial Real Estate	$353,109	28.2 %	$307,670	26.4 %	$318,341	27.0 %	$290,473	23.9 %	$271,856	23.0
Agricultural Real Estate	311,992	25.0 %	280,139	24.0 %	254,575	21.6 %	260,000	21.4 %	227,166	19.3
Real Estate Construction	32,680	2.6 %	29,607	2.5 %	37,486	3.2 %	71,647	5.9 %	75,472	6.4
Residential 1st Mortgages	140,257	11.2 %	107,421	9.2 %	103,574	8.8 %	105,850	8.7 %	105,980	9.0
Home Equity Lines and Loans	42,042	3.4 %	50,956	4.4 %	58,971	5.0 %	65,541	5.4 %	66,159	5.6
Agricultural	221,032	17.7 %	217,227	18.6 %	231,150	19.6 %	217,989	17.9 %	216,610	18.4

Commercial	143,293	11.5 %	165,089	14.2 %	165,263	14.0 %	191,949	15.8 %	202,636	17.2
Consumer & Other	5,058	0.4 %	6,935	0.7 %	8,712	0.8 %	11,400	1.0 %	13,612	1.1
Total Gross Loans	1,249,463	100.0%	1,165,044	100.0%	1,178,072	100.0%	1,214,849	100.0%	1,179,491	100.0
Less: Unearned Income	2,561		1,966		2,070		2,131		2,127	
Subtotal	1,246,902		1,163,078		1,176,002		1,212,718		1,177,364	
Less: Allowance for Loan Losses	34,217		33,017		32,261		29,813		20,034	
Loans, Net	$1,212,685		$1,130,061		$1,143,741		$1,182,905		$1,157,330	

There were no concentrations of loans exceeding 10% of total loans which were not otherwise disclosed as a category of loans in the above table.

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The following table shows the maturity distribution and interest rate sensitivity of the loan portfolio of the Company on December 31, 2012.

(in thousands)	One Year or Less	Over One Year to Five Years	Over Five Years	Total
Commercial Real Estate	$ 11,383	$ 95,103	$ 244,062	$ 350,548
Agricultural Real Estate	13,782	104,449	193,761	311,992
Real Estate Construction	12,980	14,271	5,429	32,680
Residential 1st Mortgages	2,047	8,575	129,635	140,257
Home Equity Lines and Loans	19	2,223	39,800	42,042
Agricultural	128,798	70,753	21,481	221,032
Commercial	46,677	65,402	31,214	143,293
Consumer & Other	1,307	3,200	551	5,058
Total	$ 216,993	$ 363,976	$ 665,933	$ 1,246,902
Rate Sensitivity:				
Fixed Rate	$ 33,679	$ 143,778	$ 259,186	$ 436,643
Variable Rate	183,314	220,198	406,747	810,259
Total	$ 216,993	$ 363,976	$ 665,933	$ 1,246,902
Percent	17.40 %	29.19 %	53.41 %	100.00 %

In the ordinary course of business, the Company enters into commitments to extend credit to its customers. These commitments are not reflected in the accompanying consolidated financial statements. As of December 31, 2012, the Company had entered into loan commitments amounting to $334.8 million compared to $300.6 million at December 31, 2011. In addition, letters of credit issued by the Company to guarantee the performance of a customer to a third party at December 31, 2012, and December 31, 2011, were $5.3 million and $5.1 million, respectively.

Classified Loans and Non-Performing Assets

All loans are assigned a credit risk grade using grading standards developed by bank regulatory agencies. See "Results of Operations - Provision and Allowance for Loan Losses" for more detail on risk grades. The Company utilizes the services of a third-party independent loan review firm to perform evaluations of individual loans and review the credit risk grades the Company places on loans. Loans that are judged to exhibit a higher risk profile are referred to as "classified loans," and these loans receive increased management attention. As of December 31, 2012, classified loans totaled $21.5 million compared to $42.8 million at December 31, 2011. This decline was primarily a result of $17.3 million of CRE loans being upgraded to special mention or pass during 2012.

Classified loans with higher levels of credit risk can be further designated as "impaired" loans. 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. See "Results of Operations - Provision and Allowance for Loan Losses" for further details. Impaired loans consist of: (1) non-accrual loans; and/or (2) restructured loans that are still performing (i.e., accruing interest).

Non-Accrual Loans - Accrual of interest on loans is generally discontinued when a loan becomes contractually past due by 90 days or more with respect to interest or principal. When loans are 90 days past due, but in management's judgment are well secured and in the process of collection, they may not be classified as non-accrual. When a loan is placed on non-accrual status, all interest previously accrued but not collected is reversed. Income on such loans is then recognized only to the extent that cash is received and where the future collection of principal is probable. As of December 31, 2012 and 2011, non-accrual loans totaled $9.3 million and $4.2 million. The increase in non-accrual loans was primarily a result of the stresses being felt by the Company’s dairy customers because of rising feed prices.

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Restructured Loans - 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. If the restructured loan was current on all payments at the time of restructure and management reasonably expects the borrower will continue to perform after the restructure, management may keep the loan on accrual. As of December 31, 2012, restructured loans on accrual totaled $2.3 million as compared to $4.7 million as of December 31, 2011. This decline was primarily a result of multiple commercial real estate and real estate construction loans to one borrower no longer being classified as a TDR since they were restructured at a market rate in a prior calendar year and are currently in compliance with their modified terms.

Other Real Estate - Loans where the collateral has been repossessed are classified as other real estate ("ORE") or, if the collateral is personal property, the loan is classified as other assets on the Company's financial statements.

The following table sets forth the amount of the Company's non-performing loans and ORE as of the dates indicated.

	December 31,				
(in thousands)	2012	2011	2010	2009	2008
Non-Accrual Loans					
Commercial Real Estate	$-	$1,354	$2,348	$1,294	$3,635
Agricultural Real Estate	5,423	954	1,797	2,589	-
Real Estate Construction	-	-	-	1,225	400
Residential 1st Mortgages	445	284	954	-	176
Home Equity Lines and Loans	213	194	-	325	191
Agricultural	3,198	1,202	-	1,080	-
Commercial	-	217	207	2,696	55
Consumer & Other	19	23	2	-	41
Total Non-Accrual Loans	9,298	4,228	5,308	9,209	4,498
Accruing Loans Past Due 90 Days or More					
Commercial Real Estate	-	-	-	-	769
Agricultural Real Estate	-	-	-	-	-
Real Estate Construction	-	-	-	-	-
Residential 1st Mortgages	-	-	-	-	-
Home Equity Lines and Loans	-	-	-	-	-
Agricultural	-	-	-	-	-
Commercial	-	-	-	-	-
Consumer & Other	-	-	-	-	-
Total Accruing Loans Past Due 90 Days or More	-	-	-	-	769
Total Non-Performing Loans	$9,298	$4,228	$5,308	$9,209	$5,267
Other Real Estate Owned	$2,553	$2,924	$8,039	$8,418	$4,817
Total Non-Performing Assets	$11,851	$7,152	$13,347	$17,627	$10,084
Restructured Loans (Performing)	$2,300	$4,710	$27,652	$556.00	$-
Non-Performing Loans as a Percent of Total Loans	0.74 %	0.36 %	0.45 %	0.76 %	0.45 %

Although management believes that non-performing loans are generally well-secured and that potential losses are provided for in the Company’s allowance for loan losses, there can be no assurance that future deterioration in economic conditions and/or collateral values will not result in future credit losses. See Note 5 located in “Item 8.

Financial Statements and Supplementary Data” for an allocation of the allowance classified to impaired loans.

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The Company reported $2.6 million of ORE at December 31, 2012, and $2.9 million at December 31, 2011. The decrease in ORE during 2012 was a result of the Company selling three of its ORE properties. The December 31, 2012, carrying value of $2.6 million is net of a $4.1 million reserve for ORE valuation adjustments. ORE at December 31, 2012 includes a mix of raw land and residential finished lots.

Except for those classified and non-performing loans discussed above, the Company's management is not aware of any loans as of December 31, 2012, for which known financial problems of the borrower would cause serious doubts as to the ability of these borrowers to materially comply with their present loan repayment terms, or any known events that would result in the loan being designated as non-performing at some future date. However, the Central Valley of California continues to be one of the hardest hit areas in the country during this recession. Housing prices in many areas declined as much as 60% and the economic stress eventually spread from residential real estate to other industry segments such as autos and commercial real estate. Unemployment levels remain above 15% in many areas. As a result of this combination of: (1) significant declines in real estate values over the past 60 months; and (2) continuing uncertainty in general economic conditions leading to increased unemployment and business failures; borrowers who up until this time have been able to keep current in their payments may experience deterioration in their overall financial condition, increasing the potential of default. See "Part I, Item 1A. Risk Factors."

Deposits

One of the key sources of funds to support earning assets is the generation of deposits from the Company's customer base. The ability to grow the customer base and subsequently deposits is a significant element in the performance of the Company.

The following table sets forth, by time remaining to maturity, the Company's time deposits in amounts of $100,000 or more at December 31, 2012.

(in thousands)	
Time Deposits of $100,000 or More	
Three Months or Less	$193,891
Over Three Months Through Six Months	37,397
Over Six Months Through Twelve Months	55,337
Over Twelve Months	41,389
Total Time Deposits of $100,000 or More	$328,014

Refer to the Year-To-Date Average Balances and Rate Schedules located in this "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations" for information on separate deposit categories.

At December 31, 2012, deposits totaled $1.7 billion. This represents an increase of 5.9% or $95.8 million from December 31, 2011. In addition to the Company's ongoing business development activities for deposits, the following factors positively impacted year-over-year deposit growth: (1) the Federal government's decision to permanently increase FDIC deposit insurance limits from $100,000 to $250,000 per depositor; and (2) the Company's strong financial results and position and F&M Bank's reputation as one of the most safe and sound banks in its market territory. The Company expects that, at some point, deposit customers may begin to diversify how they invest their money (e.g., move funds back into the stock market or other investments) and this could impact future deposit growth.

Although total deposits have increased 5.9% since December 31, 2011, the Company's focus has been on increasing low cost transaction and savings accounts, which have grown at a much faster pace:

Demand and interest-bearing transaction accounts increased $111.0 million or 18.2% since December 31, 2011.

Savings and money market accounts have increased $43.5 million or 8.7% since December 31, 2011.

Time deposit accounts have decreased $58.7 million or 11.3% since December 31, 2011. This decline was the continuing result of an explicit pricing strategy adopted by the Company beginning in 2009 based upon the recognition that market CD rates were greater than the yields that the Company could obtain reinvesting these funds in short-term government agency & government-sponsored entity securities or overnight Fed Funds. Beginning in April 2009, management carefully reviewed time deposit customers and reduced our deposit rates to customers that did not also have transaction, money market, and/or savings balances with us (i.e., depositors who were not “relationship customers”). Given the Company’s strong deposit growth in transaction, savings and money market accounts, this time deposit decline has not presented any liquidity issues and it has significantly enhanced the Company’s net interest margin and earnings.

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Federal Home Loan Bank Advances and Federal Reserve Bank Borrowings

Lines of Credit with the Federal Reserve Bank and Federal Home Loan Bank are other key sources of funds to support earning assets. These sources of funds are also used to manage the Bank's interest rate risk exposure; and, as opportunities arise, to borrow and invest the proceeds at a positive spread through the investment portfolio. There were no FHLB advances as of December 31, 2012 compared to $530,000 as of December 31, 2011. There were no Federal Funds purchased or advances from the FRB at December 31, 2012.

Securities Sold Under Agreement to Repurchase

Securities Sold Under Agreement to Repurchase are used as secured borrowing alternatives to FHLB Advances or FRB Borrowings. The Company had no securities sold under agreement to repurchase at December 31, 2012 and $60 million at December 31, 2011.

On March 13, 2008, the Bank entered into a $40 million medium term repurchase agreement with Citigroup as part of the Bank's interest rate risk management strategy. The repurchase agreement pricing rate was 3.20% with an embedded 3-year cap tied to 3 month Libor with a strike price of 3.3675%. The repurchase agreement was to mature March 13, 2013, and was secured by investments in agency pass through securities.

On May 30, 2008, the Company entered into a second $20 million medium term repurchase agreement with Citigroup. The repurchase agreement pricing rate was 4.19% with an embedded 3-year cap tied to 3 month Libor with a strike price of 3.17%. The repurchase agreement was to mature June 5, 2013, and was secured by investments in agency pass through securities.

On June 21, 2012, the Company terminated both repurchase agreements with Citigroup resulting in an early termination fee totaling $1.7 million, included in other non-interest expense.

Subordinated Debentures

On December 17, 2003, the Company raised $10 million through an offering of trust-preferred securities. See Note 13 located in "Item 8. Financial Statements and Supplementary Data." Although this amount is reflected as subordinated debt on the Company's balance sheet, under current regulatory guidelines, trust preferred securities qualify as regulatory capital (See "Proposed Capital Rules" for a discussion of the potential impact of proposed regulatory guidelines on this qualification). These securities accrue interest at a variable rate based upon 3-month LIBOR plus 2.85%. Interest rates reset quarterly (the next reset is March 18, 2013) and the rate was 3.2% as of December 31, 2012. The average rate paid for these securities was 3.4% in 2012 and 3.2% in 2011. Additionally, if the Company decided to defer interest on the subordinated debentures, the Company would be prohibited from paying cash dividends on the Company's common stock.

Capital

The Company relies primarily on capital generated through the retention of earnings to satisfy its capital requirements. The Company engages in an ongoing assessment of its capital needs in order to support business growth and to insure depositor protection. Shareholders' Equity totaled $205.0 million at December 31, 2012, and $189.3 million at the end of 2011.

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

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Quantitative measures established by regulation to ensure capital adequacy require the Company and the Bank to maintain minimum amounts and ratios of Total and Tier 1 capital to risk-weighted assets (as defined in the regulations), and of Tier 1 capital to average assets (as defined in the regulations). Management believes, as of December 31, 2011, that the Company and the Bank meet all capital adequacy requirements to which they are subject. In addition, the most recent notification from the FDIC categorized the Bank as "well capitalized" under the regulatory framework for prompt corrective action. There are no conditions or events since that notification that management believes have changed the Bank's category. For further information on the Company's and the Bank's risk-based capital ratios, see Note 14 located in "Item 8. Financial Statements and Supplementary Data."

As previously discussed (see "Subordinated Debentures"), in order to supplement its regulatory capital base, during December 2003 the Company issued $10 million of trust preferred securities. See Note 13 located in "Item 8. Financial Statements and Supplementary Data." On March 1, 2005, the Federal Reserve Board issued its final rule effective April 11, 2005, concerning the regulatory capital treatment of trust preferred securities ("TPS") by bank holding companies ("BHCs"). Under the final rule BHCs may include TPS in Tier 1 capital in an amount equal to 25% of the sum of core capital net of goodwill. Any portion of trust-preferred securities not qualifying as Tier 1 capital would qualify as Tier 2 capital subject to certain limitations. The Company has received notification from the Federal Reserve Bank of San Francisco that all of the Company's trust preferred securities currently qualify as Tier 1 capital. However, the capital status of the TPS may be phased out over time under proposed Basel III reforms. See "Proposed Capital Rules."

In accordance with the provisions of the "Consolidation" topic of the FASB Accounting Standards Codification ("ASC"), the Company does not consolidate the subsidiary trust, which has issued the trust-preferred securities.

In 1998, the Board approved the Company's first common stock repurchase program. This program has been extended and expanded several times since then, and most recently, on September 11, 2012, the Board of Directors approved increasing the funds available for the Company's common stock repurchase program to $20 million over the three-year period ending September 30, 2015. See "Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities."

During 2012, the Company repurchased 1,542 shares under the Stock Repurchase Program at an average per share price of $373. In 2011, the Company did not repurchase any shares under the Stock Repurchase Program. The remaining dollar value of shares that may yet be purchased under the Company's Stock Repurchase Program is approximately $20 million.

On August 5, 2008, the Board of Directors approved a Share Purchase Rights Plan (the "Rights Plan"), pursuant to which the Company entered into a Rights Agreement dated August 5, 2008, with Registrar and Transfer Company as Rights Agent. See "Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities" for further explanation.

Based upon the Company's strong capital position and continued earnings strength, the Company elected not to participate in the Federal Government's 2008 TARP capital purchase program. See "Item 1A. Risk Factors."

Proposed Capital Rules

On June 7, 2012, the FRB and FDIC issued proposed rules that would substantially amend the regulatory risk-based capital rules applicable to the Company and the Bank. The proposed rules implement the Basel III regulatory capital reforms and changes required by the Dodd-Frank Act. The proposed rules indicated that the final rules would become effective on January 1, 2013, and the changes set forth in the final rules will be phased in from January 1, 2013 through January 1, 2019. However, the agencies have recently indicated that, due to the volume of public comments received, any final rules would be delayed past January 1, 2013.

Unlike previous proposed rules, the current proposed rules are applicable to all banking organizations that are currently subject to minimum capital requirements (including national banks, state member banks, state nonmember banks, state and federal savings associations, and top-tier bank holding companies domiciled in the United States not subject to the Board's Small Bank Holding Company Policy Statement), as well as top-tier savings and loan holding companies domiciled in the United States. Previous proposed rules were applicable to all U.S. bank holding companies with consolidated assets of $50 billion or more and any nonbank financial firms that may be designated as systemically important companies.

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The proposed rules include new minimum risk-based capital and leverage ratios, which would be phased in during 2013 and 2014, and would refine the definitions of what constitutes "capital" for purposes of calculating those ratios, including the proposed phase-out of trust preferred securities as qualifying regulatory capital. The proposed new minimum capital level requirements applicable to the Company and the Bank under the proposals would be: (i) a new common equity Tier 1 capital ratio of 4.5%; (ii) a Tier 1 capital ratio of 6% (increased from 4%); (iii) a total capital ratio of 8% (unchanged from current rules); and (iv) a Tier 1 leverage ratio of 4%. The proposed rules would also establish a "capital conservation buffer" of 2.5% above each of the new regulatory minimum capital ratios which would result in the following minimum ratios: (i) a common equity Tier 1 capital ratio of 7.0%, (ii) a Tier 1 capital ratio of 8.5%, and (iii) a total capital ratio of 10.5%. The new capital conservation buffer requirement would be phased in beginning in January 2016 at 0.625% of risk-weighted assets and would increase each year until fully implemented in January 2019. An institution would be subject to limitations on paying dividends, engaging in share repurchases, and paying discretionary bonuses if its capital level falls below the buffer amount. These limitations would establish a maximum percentage of eligible retained income that could be utilized for such actions. These proposed rules would also adjust the prompt corrective action categories accordingly.

The proposed rules also implement other revisions to the current capital rules such as recognition of all unrealized gains and losses on available for sale debt and equity securities, and provide that certain instruments, such as TPS, that will no longer qualify as capital would be phased out over time.

Critical Accounting Policies and Estimates

This “Management’s Discussion and Analysis of Financial Condition and Results of Operations” is based upon the Company’s consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. In preparing the Company’s financial statements management makes estimates and judgments that affect the reported amounts of assets, liabilities, revenues, and expenses. Management believes that the most significant subjective judgments that it makes include the following:

Allowance for Loan Losses - As a financial institution, which assumes lending and credit risks as a principal element in its business, the Company anticipates that credit losses will be experienced in the normal course of business. Accordingly, the allowance for loan losses is maintained at a level considered adequate by management to provide for losses that are inherent in the portfolio. The allowance is increased by provisions charged to operating expense and reduced by net charge-offs. Management employs a systematic methodology for determining the allowance for loan losses. On a quarterly basis, management reviews the credit quality of the loan portfolio and considers problem loans, delinquencies, internal credit reviews, current economic conditions, loan loss experience, and other factors in determining the adequacy of the allowance balance.

While the Company utilizes a systematic methodology in determining its allowance, the allowance is based on estimates, and ultimate losses may vary from current estimates. The estimates are reviewed periodically and, as adjustments become necessary, are reported in earnings in the periods in which they become known. For additional information, see Note 5 located in “Item 8. Financial Statements and Supplementary Data.”

Fair Value - The Company discloses the fair value of financial instruments and the methods and significant assumptions used to estimate those fair values. The estimated fair value amounts have been determined by the Company using available market information and appropriate valuation methodologies. The use of assumptions and various valuation techniques, as well as the absence of secondary markets for certain financial instruments, will likely reduce the comparability of fair value disclosures between financial institutions. In some cases, book value is a reasonable estimate of fair value due to the relatively short period of time between origination of the instrument and its expected realization. For additional information, see “Item 7A. Quantitative and Qualitative Disclosures About Market Risk – Credit Risk” and Notes 17 and 18 located in “Item 8. Financial Statements and Supplementary Data.”

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Income Taxes - The Company uses the liability method of accounting for income taxes. This method results in the recognition of deferred tax assets and liabilities that are reflected at currently enacted income tax rates applicable to the period in which the deferred tax assets or liabilities are expected to be realized or settled. As changes in tax laws or rates are enacted, deferred tax assets and liabilities are adjusted through the provision for income taxes. The deferred provision for income taxes is the result of the net change in the deferred tax asset and deferred tax liability balances during the year. This amount combined with the current taxes payable or refundable results in the income tax expense for the current year. For additional information, see Note 1 located in "Item 8. Financial Statements and Supplementary Data."

Off-Balance Sheet Arrangements

Off-balance sheet arrangements are any contractual arrangement to which an unconsolidated entity is a party, under which the Company has: (1) any obligation under a guarantee contract; (2) a retained or contingent interest in assets transferred to an unconsolidated entity or similar arrangement that serves as credit, liquidity, or market risk support to that entity for such assets; (3) any obligation under certain derivative instruments; or (4) any obligation under a material variable interest held by us in an unconsolidated entity that provides financing, liquidity, market risk, or credit risk support to the Company, or engages in leasing, hedging, or research and development services with the Company. The Company had the following off balance sheet commitments as of the dates indicated.

Off Balance Sheet Arrangements

(in thousands)	December 31, 2012	December 31, 2011
Commitments to Extend Credit	$ 334,772	$ 300,572
Letters of Credit	5,281	5,087
Performance Guarantees Under Interest Rate Swap Contracts Entered Into Between Our Borrowing Customers and Third Parties	1,796	416

The Company's exposure to credit loss in the event of nonperformance by the other party with regard to standby letters of credit, undisbursed loan commitments, and financial guarantees is represented by the contractual notional amount of those instruments. Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. The Company uses the same credit policies in making commitments and conditional obligations as it does for recorded balance sheet items. The Company may or may not require collateral or other security to support financial instruments with credit risk. Evaluations of each customer's creditworthiness are performed on a case-by-case basis.

Aggregate Contractual Obligations and Commitments

The following table presents, as of December 31, 2012, our significant and determinable contractual obligations by payment date. The payment amounts represent those amounts contractually due to the recipient and do not include any unamortized premiums or discounts, hedge basis adjustments, or other similar carrying value adjustments. For further information on the nature of each obligation type, see applicable note disclosures located in "Item 8. Financial Statements and Supplementary Data."

Contractual Obligations and Commitments

(in thousands)	Total	1 Year or Less	2-3 Years	4-5 Years	More Than 5 Years
Operating Lease Obligations	$994	$279	$579	$136	$-
Long-Term Subordinated Debentures	10,310	-	-	-	10,310
Deferred Compensation (1)	27,520	373	717	376	26,054

Total	$38,824	$652	$1,296	$512	$36,364

(1)These amounts represent obligations to participants under the Company's various non-qualified deferred compensation plans. See Note 16 located in “Item 8. Financial Statements and Supplementary Data.”

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Quarterly Unaudited Financial Data

The following tables set forth certain unaudited historical quarterly financial data for each of the eight consecutive quarters in 2012 and 2011. This information is derived from unaudited consolidated financial statements that include, in management's opinion, all adjustments (consisting of normal recurring adjustments) necessary for a fair presentation when read in conjunction with the consolidated financial statements and notes thereto included elsewhere in this Form 10-K.

2012 (in thousands except per share data)	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	Total
Total Interest Income	$19,966	$19,813	$19,499	$19,213	$78,491
Total Interest Expense	1,688	1,555	1,033	864	5,140
Net Interest Income	18,278	18,258	18,466	18,349	73,351
Provision for Loan Losses	220	280	600	750	1,850
Net Interest Income After Provision for Loan Losses	18,058	17,978	17,866	17,599	71,501
Total Non-Interest Income	3,923	2,811	4,053	3,323	14,110
Total Non-Interest Expense	12,122	12,671	11,760	11,724	48,277
Income Before Income Taxes	9,859	8,118	10,159	9,198	37,334
Provision for Income Taxes	3,669	2,956	3,827	3,533	13,985
Net Income	$6,190	$5,162	$6,332	$5,665	$23,349
Earnings Per Share	$7.94	$6.63	$8.13	$7.29	$29.99

2011 (in thousands except per share data)	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	Total
Total Interest Income	$20,531	$20,535	$20,861	$20,427	$82,354
Total Interest Expense	2,165	2,023	1,968	1,818	7,974
Net Interest Income	18,366	18,512	18,893	18,609	74,380
Provision for Loan Losses	525	3,925	900	1,425	6,775
Net Interest Income After Provision for Loan Losses	17,841	14,587	17,993	17,184	67,605
Total Non-Interest Income	3,334	2,995	1,770	4,175	12,274
Total Non-Interest Expense	11,436	11,233	9,821	12,538	45,028
Income Before Income Taxes	9,739	6,349	9,942	8,821	34,851
Provision for Income Taxes	3,613	2,194	3,675	3,160	12,642
Net Income	$6,126	$4,155	$6,267	$5,661	$22,209
Earnings Per Share	$7.86	$5.33	$8.04	$7.26	$28.49

Item 7A. Quantitative and Qualitative Disclosures About Market Risk

Risk Management

The Company has adopted risk management policies and procedures, which aim to ensure the proper control and management of all risk factors inherent in the operation of the Company, most importantly credit risk, interest rate risk and liquidity risk. These risk factors are not mutually exclusive. It is recognized that any product or service offered by the Company may expose the Company to one or more of these risk factors.

Credit Risk

Credit risk is the risk to earnings or capital arising from an obligor's failure to meet the terms of any contract or otherwise fail to perform as agreed. Credit risk is found in all activities where success depends on counterparty, issuer, or borrower performance.

Credit risk in the investment portfolio and correspondent bank accounts is addressed through defined limits in the Company's policy statements. In addition, certain securities carry insurance to enhance credit quality of the bond.

In order to control credit risk in the loan portfolio 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. However, 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 allowance for loan losses is maintained at a level considered by management to be adequate to provide for risks inherent in the loan portfolio. The allowance is increased by provisions charged to operating expense and reduced by net charge-offs.

The Company's methodology for assessing the appropriateness of the allowance is applied on a regular basis and considers all loans. The systematic methodology consists of two major parts.

Part 1- includes a detailed analysis of the loan portfolio in two phases. The first phase is conducted in accordance with the "Receivables" topic of the FASB ASC. Individual loans are reviewed to identify loans for impairment. A loan is impaired when principal and interest are deemed uncollectible in accordance with the original contractual terms of the loan. Impairment is measured as either the expected future cash flows discounted at each loan's effective interest rate, the fair value of the loan's collateral if the loan is collateral dependent, or an observable market price of the loan, if one exists. Upon measuring the impairment, the Company will ensure an appropriate level of allowance is present or established.

Central to the first phase of the analysis of the loan portfolio is the loan risk rating system. The originating credit officer assigns borrowers an initial risk rating, which is based primarily on a thorough analysis of each borrower's financial position in conjunction with industry and economic trends. Approvals are made based upon the amount of inherent credit risk specific to the transaction and are reviewed for appropriateness by senior credit administration personnel. Credits are monitored by credit administration personnel for deterioration in a borrower's financial condition, which would impact the ability of the borrower to perform under the contract. Risk ratings are adjusted as necessary. Risk ratings are reviewed by both the Company's independent third-party credit examiners and bank examiners from the DFI and FDIC.

Based on the risk rating system, specific allowances are established in cases where management has identified significant conditions or circumstances related to a credit that management believes indicates that the loan is impaired and there is a probability of loss. Management performs a detailed analysis of these loans, including, but not limited to, cash flows, appraisals of the collateral, conditions of the marketplace for liquidating the collateral, and assessment of the guarantors. Management then determines the inherent loss potential and allocates a portion of the allowance for losses as a specific allowance for each of these credits.

The second phase is conducted by segmenting the loan portfolio by risk rating and into groups of loans with similar characteristics in accordance with the "Contingency" topic of the FASB ASC. In this second phase, groups of loans with similar characteristics are reviewed and the appropriate allowance factor is applied based on the historical average charge-off rate for each particular group of loans.

Part 2 - considers qualitative internal and external factors that may affect a loan's collectability, is based upon management's evaluation of various conditions, the effects of which are not directly measured in the determination of the historical and specific allowances. The evaluation of the inherent loss with respect to these conditions is subject to a higher degree of uncertainty because they are not identified with specific problem credits or portfolio segments. The conditions evaluated in connection with the second element of the analysis of the allowance include, but are not limited to the following conditions that existed as of the balance sheet date:

§ general economic and business conditions affecting the key lending areas of the Company;
§ credit quality trends (including trends in collateral values, delinquencies and non-performing loans);

- § loan volumes, growth rates and concentrations;
- § loan portfolio seasoning;
- § specific industry and crop conditions;
- § recent loss experience; and
- § duration of the current business cycle.

Management reviews these conditions in discussion with the Company's senior credit officers. To the extent that any of these conditions is evidenced by a specifically identifiable impaired credit or portfolio segment as of the evaluation date, management's estimate of the effect of such condition may be reflected as a specific allowance applicable to such credit or portfolio segment. Where any of these conditions is not evidenced by a specifically identifiable impaired credit or portfolio segment as of the evaluation date, management's evaluation of the inherent loss related to such condition is reflected in the second major element of the allowance.

Management believes that based upon the preceding methodology, and using information currently available, the allowance for loan losses at December 31, 2012 was adequate. No assurances can be given that future events may not result in increases in delinquencies, non-performing loans, or net loan charge-offs that would require increases in the provision for loan losses and thereby adversely affect the results of operations.

Interest Rate Risk

The mismatch between maturities of interest sensitive assets and liabilities results in uncertainty in the Company's earnings and economic value and is referred to as interest rate risk. The Company does not attempt to predict interest rates and positions the balance sheet in a manner, which seeks to minimize, to the extent possible, the effects of changing interest rates.

The Company measures interest rate risk in terms of potential impact on both its economic value and earnings. The methods for governing the amount of interest rate risk include: (1) analysis of asset and liability mismatches (Gap analysis); (2) the utilization of a simulation model; and (3) limits on maturities of investment, loan, and deposit products, which reduces the market volatility of those instruments.

The Gap analysis measures, at specific time intervals, the divergence between earning assets and interest bearing liabilities for which repricing opportunities will occur. A positive difference, or Gap, indicates that earning assets will reprice faster than interest-bearing liabilities. This will generally produce a greater net interest margin during periods of rising interest rates and a lower net interest margin during periods of declining interest rates. Conversely, a negative Gap will generally produce a lower net interest margin during periods of rising interest rates and a greater net interest margin during periods of decreasing interest rates.

The interest rates paid on deposit accounts do not always move in unison with the rates charged on loans. In addition, the magnitude of changes in the rates charged on loans is not always proportionate to the magnitude of changes in the rate paid for deposits. Consequently, changes in interest rates do not necessarily result in an increase or decrease in the net interest margin solely as a result of the differences between repricing opportunities of earning assets or interest bearing liabilities.

The Company also utilizes the results of a dynamic simulation model to quantify the estimated exposure of net interest income to sustained interest rate changes. The sensitivity of the Company's net interest income is measured over a rolling one-year horizon.

The simulation model estimates the impact of changing interest rates on interest income from all interest earning assets and the interest expense paid on all interest bearing liabilities reflected on the Company's balance sheet. This sensitivity analysis is compared to policy limits, which specify a maximum tolerance level for net interest income exposure over a one-year horizon assuming no balance sheet growth, given a 200 basis point upward and a 100 basis point downward shift in interest rates. A shift in rates over a 12-month period is assumed. Results that exceed policy limits, if any, are analyzed for risk tolerance and reported to the Board with appropriate recommendations. At December 31, 2012, the Company's estimated net interest income sensitivity to changes in interest rates, as a percent of net interest income was an increase in net interest income of 0.62% if rates increase by 200 basis points and a decrease in net interest income of 0.55% if rates decline 100 basis points.

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The estimated sensitivity does not necessarily represent a Company forecast and the results may not be indicative of actual changes to the Company's net interest income. These estimates are based upon a number of assumptions including: the nature and timing of interest rate levels including yield curve shape; prepayments on loans and securities; pricing strategies on loans and deposits; replacement of asset and liability cash flows; and other assumptions. While the assumptions used are based on current economic and local market conditions, there is no assurance as to the predictive nature of these conditions including how customer preferences or competitor influences might change.

Liquidity Risk

Liquidity risk is the risk to earnings or capital resulting from the Company's inability to meet its obligations when they come due without incurring unacceptable losses. It includes the ability to manage unplanned decreases or changes in funding sources and to recognize or address changes in market conditions that affect the Company's ability to liquidate assets or acquire funds quickly and with minimum loss of value. The Company endeavors to maintain a cash flow adequate to fund operations, handle fluctuations in deposit levels, respond to the credit needs of borrowers, and to take advantage of investment opportunities as they arise.

The Company's principal operating sources of liquidity include (see "Item 8. Financial Statements and Supplementary Data – Consolidated Statements of Cash Flows") cash and cash equivalents, cash provided by operating activities, principal payments on loans, proceeds from the maturity or sale of investments, and growth in deposits. To supplement these operating sources of funds the Company maintains Federal Funds credit lines of $61 million and repurchase lines of $100 million with major banks. In addition, as of December 31, 2012 the Company has available borrowing capacity of $301.6 million at the Federal Home Loan Bank and $298.3 million at the Federal Reserve Bank.

At December 31, 2012, the Company had available sources of liquidity, which included cash and cash equivalents and unpledged investment securities of approximately $287 million, which represents 14.7% of total assets.

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Item 8. Financial Statements and Supplementary Data

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AND FINANCIAL STATEMENT SCHEDULES

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Farmers & Merchants Bancorp

Report of Management on Internal Control Over Financial Reporting

Management is responsible for establishing and maintaining adequate internal control over financial reporting at Farmers & Merchants Bancorp ("the Company"). Internal control over financial reporting includes controls over the preparation of financial statements in accordance with the instructions to the Consolidated Financial Statements for Bank Holding Companies (Form FR Y-9C) to comply with the reporting requirements of Part 363 of the Federal Deposit Insurance Corporation Rules and Regulations.

Management has assessed the effectiveness of the Company's internal control over financial reporting as of December 31, 2012, based on criteria described in "Internal Control-Integrated Framework" issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on that assessment, management concluded that the Company maintained effective internal control over financial reporting as of December 31, 2012.

Crowe Horwath LLP, the independent registered public accounting firm that audited the financial statements included in this Annual Report, was engaged to express an opinion as to the fairness of presentation of such financial statements. Crowe Horwath LLP was also engaged to audit the effectiveness of the Company's internal control over financial reporting. The report of Crowe Horwath LLP follows this report.

/s/ Kent A. Steinwert	/s/ Stephen W. Haley
Kent A. Steinwert Chairman, President & Chief Executive Officer	Stephen W. Haley Executive Vice President & Chief Financial Officer

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Crowe Horwath LLP
Independent Member Crowe Horwath International

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Shareholders and Board of Directors
Farmers & Merchants Bancorp
Lodi, California

We have audited the accompanying consolidated balance sheets of Farmers & Merchants Bancorp and subsidiaries (the "Company") as of December 31, 2012 and 2011, and the related consolidated statements of income, comprehensive income, changes in shareholders' equity, and cash flows for the years then ended. We also have audited the Company's internal control over financial reporting as of December 31, 2012, based on criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the "COSO criteria"). The Company's management is responsible for these consolidated financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying Report of Management on Internal Control over Financial Reporting. Our responsibility is to express an opinion on these consolidated financial statements and an opinion on the Company's internal control over financial reporting based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the consolidated financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Farmers & Merchants Bancorp and subsidiaries as of December 31, 2012 and 2011, and the results of their operations and their cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America. Also, in our opinion, Farmers & Merchants Bancorp and subsidiaries maintained, in all material respects, effective internal control over financial reporting as of December 31, 2012, based on the COSO criteria.

/s/ Crowe Horwath LLP

Crowe Horwath LLP

San Francisco, California
March 13, 2013

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Shareholders and Board of Directors
Farmers & Merchants Bancorp
Lodi, California

We have audited the accompanying consolidated statement of income of Farmers & Merchants Bancorp and subsidiaries (the "Company") and the related consolidated statements of comprehensive income, changes in shareholders' equity, and cash flows for the year ended December 31, 2010. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the results of operations and cash flows of Farmers & Merchants Bancorp and subsidiaries for the year ended December 31, 2010, in conformity with U.S. generally accepted accounting principles.

/s/ Perry-Smith LLP

Sacramento, California
March 8, 2011

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Farmers & Merchants Bancorp
Consolidated Balance Sheets

(in thousands except share and per share data)

	December 31,	
Assets	2012	2011
Cash and Cash Equivalents:		
Cash and Due from Banks	$47,366	$45,112
Interest Bearing Deposits with Banks	82,060	56,548
Total Cash and Cash Equivalents	129,426	101,660
Investment Securities:		
Available-for-Sale	417,991	479,820
Held-to-Maturity	68,392	63,092
Total Investment Securities	486,383	542,912
Loans:	1,246,902	1,163,078
Less: Allowance for Loan Losses	34,217	33,017
Loans, Net	1,212,685	1,130,061
Premises and Equipment, Net	22,901	24,058
Bank Owned Life Insurance	50,253	47,418
Interest Receivable and Other Assets	73,038	73,575
Total Assets	$1,974,686	$1,919,684
Liabilities		
Deposits:		
Demand	$462,251	$389,639
Interest-Bearing Transaction	259,141	220,736
Savings and Money Market	541,526	498,011
Time	459,108	517,811
Total Deposits	1,722,026	1,626,197
Securities Sold Under Agreement to Repurchase	-	60,000
Federal Home Loan Bank Advances	-	530
Subordinated Debentures	10,310	10,310
Interest Payable and Other Liabilities	37,317	33,301
Total Liabilities	1,769,653	1,730,338
Commitments & Contingencies (See Note 19)		
Shareholders' Equity		
Preferred Stock: No Par Value. 1,000,000 Shares Authorized, None Issued or Outstanding	-	-
Common Stock: Par Value $0.01, 7,500,000 and 20,000,000 Shares Authorized, 777,882 and 779,424 Shares Issued and Outstanding at December 31, 2012 and 2011, respectively	8	8
Additional Paid-In Capital	75,014	75,590
Retained Earnings	123,012	109,081
Accumulated Other Comprehensive Gain	6,999	4,667

Total Shareholders' Equity	205,033	189,346
Total Liabilities and Shareholders' Equity	$1,974,686	$1,919,684

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

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Farmers & Merchants Bancorp
Consolidated Statements of Income

(in thousands except per share data)

	Year Ended December 31, 2012	2011	2010
Interest Income			
Interest and Fees on Loans	$65,798	$70,180	$72,643
Interest on Deposits with Banks	110	117	91
Interest on Investment Securities:			
Taxable	9,940	9,490	8,971
Exempt from Federal Tax	2,643	2,567	2,756
Total Interest Income	78,491	82,354	84,461
Interest Expense			
Deposits	3,739	5,463	7,168
Borrowed Funds	1,054	2,181	2,184
Subordinated Debentures	347	330	333
Total Interest Expense	5,140	7,974	9,685
Net Interest Income			