FARMERS & MERCHANTS BANCORP
Form 10-K
March 15, 2019

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

FORM 10-K

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

For the fiscal year ended December 31, 2018

OR

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

Commission File Number: 000-26099

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

Delaware	94-3327828
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

111 W. Pine Street, Lodi, California	95240
(Address of principal executive offices)	(Zip Code)

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

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

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

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

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

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

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

Large accelerated filer	Accelerated filer
Non-accelerated filer	Smaller reporting company
Emerging growth company	

(Do not check if a smaller reporting company)

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

The aggregate market value of the Registrant's common stock held by non-affiliates on June 30, 2018 (based on the last reported trade on June 30, 2018) was $584,604,000.

The number of shares of Common Stock outstanding as of February 28, 2019: 783,721

Documents Incorporated by Reference:
Portions of the definitive Proxy Statement for the 2019 Annual Meeting of Stockholders to be filed with the Securities and Exchange Commission pursuant to Regulation 14A are incorporated by reference in Part III, Items 10 through 14.

FARMERS & MERCHANTS BANCORP
FORM 10-K

TABLE OF CONTENTS

Table of Contents

Introduction – Forward Looking Statements

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

Such factors include, but are not limited to, the following: (1) economic conditions in the Central Valley of California; (2) significant changes in interest rates and loan prepayment speeds; (3) credit risks of lending and investment activities; (4) changes in federal and state banking laws or regulations; (5) competitive pressure in the banking industry; (6) changes in governmental fiscal or monetary policies; (7) uncertainty regarding the economic outlook resulting from the continuing war on terrorism, as well as actions taken or to be taken by the U.S. or other governments as a result of further acts or threats of terrorism; (8) water management issues in California and the resulting impact on the Company’s agricultural customers; (9) expansion into new geographic markets and new lines of business; and (10) other factors discussed in Item 1A. Risk Factors.

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

PART I

Item 1. Business

General Development of the Business

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

During 2016, the Company completed the acquisition of Delta National Bancorp, the parent company of Delta Bank, N.A., headquartered in Manteca, California. This enabled the Company to expand its presence in to both Manteca and Riverbank.

During 2018, the Company completed the acquisition of Bank of Rio Vista., headquartered in Rio Vista, California. This provided the Company entry into both Rio Vista and Walnut Grove, enhancing the Bank’s market share in Lodi.

In January 2018, the Company opened a loan production office (“LPO”) in Napa, California, which was converted to a full service branch in the third quarter of 2018.

In addition to 29 full-service branches, the Bank serves the needs of its customers through two stand-alone ATMs located on the grounds of the Lodi Grape Festival and in the Trilogy Residential Community clubhouse in Rio Vista. In 2007, the Bank began offering certain banking 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 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, 2018, consisted of 783,721 shares of common stock, $0.01 par value and no shares of preferred stock issued. The Bank is the Company's principal asset.

Table of Contents

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

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

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

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

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

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

Acquisition of Bank of Rio Vista (“BRV”)

On April 5, 2017, the Company purchased 196 BRV common shares or 4.9% of the common shares outstanding. On July 12, 2017 the Company purchased an additional 1,382 common shares, representing in aggregate 39.45% of BRV’s 4,000 common shares outstanding. In addition, between October, 2017 and March 26, 2018 the Company purchased another 8 BRV common shares bringing our total to 39.65% of BRV’s common shares outstanding. Despite the significant investment in BRV, this initial investment was accounted for under the cost method rather than the equity method because control of BRV remained with a family group through their ownership of a substantial portion of the remaining shares.

On March 26, 2018, BRV and the Company entered into a definitive agreement for the acquisition of BRV’s remaining shares not already owned by the Company. Because of the definitive agreement, the Company began accounting for this investment under the equity method—retroactive to January 1, 2018 (the beginning of the quarter in which the definitive agreement was signed). Subsequent to January 1, 2018, the Company recorded its portion of BRV’s income (loss) as in increase (decrease) in the carrying value of its investment in BRV and dividends received were recorded as a reduction in the carrying value of the investment. Note that under ASU 2016-07, retroactive restatement of prior periods under which the cost method was used is no longer required.

The transaction to acquire the remaining shares of BRV closed on October 10, 2018. Under the terms of the definitive agreement, BRV shareholders received $11,900 per share in cash for the remaining 60.35% of BRV’s shares outstanding. The transaction value for the remaining shares of common stock, not owned by the Company, was approximately $28.73 million, resulting in a total purchase price of $40.73 million. The Company engaged in this transaction with the expectation that it would be accretive to income and add a new market area with a demographic profile consistent with many of the current Central Valley markets served by the Company. Goodwill resulted from this transaction due to the expected synergies and economies of scale.

Table of Contents

For additional information on the acquisition, see Note 2, located in "Item 8. Financial Statements and Supplementary Data."

Service Area

Since 2014, the Company has broadened its geographic footprint by opening offices in Walnut Creek, Concord and Napa. The Company continues to look for opportunities to further expand its branch network in the East Bay area of San Francisco.

At the present time, the Company's primary service area remains the mid Central Valley of California, including Sacramento, San Joaquin, Stanislaus and Merced counties, where we operate 26 full-service branches and 2 stand-alone ATMs. This area encompasses:

- Sacramento Metropolitan Statistical Area ("MSA"), with branches in Sacramento, Elk Grove and Galt. This MSA has a Population of 2.35 million and a Per Capita Income of approximately $55,300. The MSA includes significant employment in the following sectors: state and local government; agriculture; and trade, transportation and utilities. Unemployment currently stands at 3.7%.

- Stockton MSA, with branches in Lodi, Linden, Stockton, and Manteca. This MSA has a Population of 0.76 million and a Per Capita Income of approximately $44,200. 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 6.0%.

- Modesto MSA, with branches in Modesto, Riverbank and Turlock. This MSA has a Population of 0.55 million and a Per Capita Income of approximately $44,500. 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 6.3%.

- Merced MSA with branches in Hilmar and Merced. This MSA has a Population of 0.28 million and a Per Capita Income of approximately $40,500. The MSA includes significant employment in the following sectors: agriculture; state and local government; and trade, transportation and utilities. Unemployment currently stands at 8.1%.

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

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

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

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

The Company provides a broad complement of lending products, including commercial, commercial real estate, real estate construction, agribusiness, consumer, credit card, residential real estate loans, and equipment leases.

Commercial products include term loans, leases, 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.

Table of Contents

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

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

Employees

At December 31, 2018, the Company employed 376 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 institutions, 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.

Government Policies

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

The business of the Company is also influenced by the monetary and fiscal policies of the federal government and the policies of regulatory agencies, particularly the FRB. The FRB implements national monetary policies (with objectives such as curbing inflation and combating recession) through its open-market operations in U.S. Government securities by adjusting the required level of reserves for depository institutions subject to its reserve requirements, and by varying the target federal funds and discount rates applicable to borrowings by depository institutions. The actions of the FRB in these areas influence the growth of bank loans & leases, investments, and deposits and also affect interest rates earned on interest-earning assets and paid on interest-bearing liabilities. The nature and impact on the

Company of any future changes in monetary and fiscal policies cannot be predicted.

Table of Contents

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

Supervision and Regulation

General

Bank holding companies and banks are extensively regulated under both federal and state law. The regulation is intended primarily for the protection of the banking system and the deposit insurance fund and not for the benefit of stockholders of the Company. This supervisory and regulatory framework subjects banks and bank holding companies to regular examination by their respective regulatory agencies, which results in examination reports and ratings that, while not publicly available, can affect the conduct and growth of their businesses. These examinations consider not only compliance with applicable laws and regulations, but also capital levels, asset quality and risk, management ability and performance, earnings, liquidity, and various other factors. The regulatory agencies generally have broad discretion to impose restrictions and limitations on the operations of a regulated entity where the agencies determine, among other things, that such operations are unsafe or unsound, fail to comply with applicable law or are otherwise inconsistent with laws and regulations or with the supervisory policies of these agencies.

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."

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.

Table of Contents

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

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

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

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

The Bank

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

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

The Dodd Frank Wall Street Reform and Consumer Protection Act (the "Dodd Frank Act") - The Dodd-Frank Act implemented sweeping reform across the U.S. financial regulatory framework, including, among other changes:

- creating a Financial Stability Oversight Council tasked with identifying and monitoring systemic risks in the financial system;

- creating the Consumer Financial Protection Bureau ("CFPB"), which is responsible for implementing, examining and enforcing compliance with federal consumer financial protection laws;

- requiring the FDIC to make its capital requirements for insured depository institutions countercyclical, so that capital requirements increase in times of economic expansion and decrease in times of economic contraction;

.

imposing more stringent capital requirements on bank holding companies and subjecting certain activities, including interstate mergers and acquisitions, to heightened capital conditions;

Table of Contents

- changing the assessment base for federal deposit insurance from the amount of the insured deposits held by the depository institution to the depository institution's average total consolidated assets less tangible equity, eliminating the ceiling on the size of the FDIC's Deposit Insurance Fund and increasing the floor of the size of the FDIC's Deposit Insurance Fund;

- eliminating all remaining restrictions on interstate banking by authorizing state banks to establish de novo banking offices in any state that would permit a bank chartered in that state to open a banking office at that location;

- repealing the federal prohibitions on the payment of interest on demand deposits, thereby permitting depository institutions to pay interest on business transaction and other accounts; and

- in the so-called "Volcker Rule," subject to numerous exceptions, prohibiting depository institutions and affiliates from certain investments in, and sponsorship of, hedge funds and private equity funds and from engaging in proprietary trading.

On February 3, 2017, President Trump signed an executive order calling for his administration to review existing U.S. financial laws and regulations, including the Dodd-Frank Act, in order to determine their consistency with a set of "core principles" of financial policy.

President Trump recently signed the Economic Growth, Regulatory Relief and Consumer Protection Act (the "Economic Growth Act"), which repeals or modifies certain provisions of the Dodd-Frank Act and eases regulations on all but the largest banks. In addition, the Economic Growth Act's highlights also include regulatory relief for certain institutions, whereby among other things, it simplifies capital calculations by requiring regulators to adopt a threshold for a community bank leverage ratio of between 8% to 10%. Institutions under $10 billion in assets that meet such community bank leverage ratio will automatically be deemed to be well-capitalized, although regulators retain the flexibility to determine that a depository institution may not qualify for the community bank leverage ratio test based on the institution's risk profile, and exempts community banks from Section 13 of the Bank Holding Company Act if they have less than $10 billion in total consolidated assets; and exempts banks with less than $10 billion in assets, and total trading assets and liabilities not exceeding more than five percent of their total assets, from the Volcker Rule restrictions on trading with their own capital. The Economic Growth Act also adds certain protections for consumers, including veterans and active duty military personnel, expanded credit freezes and creation of an identity theft protection database. The Economic Growth Act also makes changes for bank holding companies, as it raises the threshold for automatic designation as a systemically important financial institution from $50 billion to $250 billion in assets, subjects banks with $100 billion to $250 billion in total assets to periodic stress tests, exempts from stress test requirements entirely banks with under $100 billion in assets, and requires the federal banking regulators to, within 180 days of passage, raise the asset threshold under the Small Bank Holding Company Policy Statement from $1 billion to $3 billion. The Economic Growth Act also adds certain protections for student borrowers.

The federal bank regulatory agencies have jointly issued a notice of proposed rulemaking setting forth the proposals for the shortened call reports. The proposed rule also describes which depository institutions may take advantage of the shortened call reports. The proposal would reduce the data items required to be reported in the first and third quarters by approximately 37% and would go into effect for the call report to be filed for the quarter ending March 31, 2019. Assuming the proposed rule is enacted in substantially the same form as the proposed rule, this would decrease the reporting obligations for the Bank in its first and third quarter call reports.

Many aspects of the Dodd-Frank Act are subject to rulemaking and will take effect over several years, making it difficult to anticipate the overall financial impact on us. In addition, the Economic Growth Act modifies several provisions in the Dodd-Frank Act, but are subject to implementing regulations. Although the reforms primarily target systemically important financial service providers (which the Bank is not, the Dodd-Frank Act's influence has and is expected to continue to filter down in varying degrees to smaller institutions over time. We will continue to evaluate the effect of the Dodd-Frank Act; however, in many respects, the ultimate impact of the Dodd-Frank Act will not be fully known for years, and no current assurance may be given that the Dodd-Frank Act, or any other new legislative changes, will not have a negative impact on the results of operations and financial condition of the Company and the Bank.

Table of Contents

Capital Standards

The federal banking agencies have risk-based capital adequacy guidelines intended to provide a measure of capital adequacy that reflects the degree of risk associated with a banking organization's operations, both for transactions reported on the balance sheet as assets and for transactions, such as letters of credit and recourse arrangements, that are recorded as off-balance sheet items. In 2013, the FRB, FDIC, and Office of the Comptroller of the Currency issued final rules (the "Basel III Capital Rules") establishing a new comprehensive capital framework for U.S. banking organizations. The rules implement the Basel Committee's December 2010 framework, commonly referred to as Basel III, for strengthening international capital standards, as well as implementing certain provisions of the Dodd-Frank Act.

The Basel III Capital Rules became effective for the Company and the Bank on January 1, 2015 (subject to phase-in periods for some of their components). The Basel III Capital Rules: (i) introduce a new capital measure called Common Equity Tier 1 ("CET1"), and a related regulatory capital ratio of CET1 to risk-weighted assets; (ii) specify that Tier 1 capital consists of CET1 and "Additional Tier 1 capital" instruments, which are instruments treated as Tier 1 instruments under the prior capital rules that meet certain revised requirements; (iii) mandate that most deductions or adjustments to regulatory capital measures be made to CET1 and not to the other components of capital; and (iv) expand the scope of the deductions from and adjustments to capital, as compared to existing regulations. Under the Basel III Capital Rules, for most banking organizations, the most common form of additional Tier 1 capital is noncumulative perpetual preferred stock and the most common form of Tier 2 capital is subordinated notes and a portion of the allowance for loan and lease losses, in each case, subject to the Basel III Capital Rules' specific requirements.

Under the Basel III Capital Rules, the following are the initial minimum capital ratios applicable to the Company and the Bank:

- 4.0% Tier 1 leverage ratio;
- 4.5% CET1 to risk-weighted assets;
- 6.0% Tier 1 capital (that is, CET1 plus Additional Tier 1 capital) to risk-weighted assets; and
- 8.0% total capital (that is, Tier 1 capital plus Tier 2 capital) to risk-weighted assets.

The Basel III Capital Rules also introduced a "capital conservation buffer," composed entirely of CET1, on top of these minimum risk-weighted asset ratios. The capital conservation buffer is designed to absorb losses during periods of economic stress. Banking institutions with a ratio of CET1 to risk-weighted assets above the minimum but below the capital conservation buffer will face constraints on dividends, equity repurchases and compensation based on the amount of the shortfall. The implementation of the capital conservation buffer began on January 1, 2016 and was phased in over a three-year period (increasing by that amount on each subsequent January 1, until it reached 2.5% on January 1, 2019). The Company and the Bank must now maintain the following minimum capital ratios:

- 4.0% Tier 1 leverage ratio;
- 4.5% CET1 to risk-weighted assets, plus the capital conservation buffer, effectively resulting in a minimum ratio of CET1 to risk-weighted assets of at least 7%;

- 6.0% Tier 1 capital to risk-weighted assets, plus the capital conservation buffer, effectively resulting in a minimum Tier 1 capital ratio of at least 8.5%; and

- 8.0% total capital to risk-weighted assets, plus the capital conservation buffer, effectively resulting in a minimum total capital ratio of at least 10.5%.

Table of Contents

The Basel III Capital Rules provide for a number of deductions from and adjustments to CET1. These include, for example, the requirement that (i) mortgage servicing rights, (ii) deferred tax assets arising from temporary differences that could not be realized through net operating loss carrybacks, and (iii) significant investments in non-consolidated financial entities be deducted from CET1 to the extent that any one such category exceeds 10% of CET1 or all such items, in the aggregate, exceed 15% of CET1. Implementation of the deductions and other adjustments to CET1 began on January 1, 2015 and were phased-in over a four-year period ending on January 1, 2019 (beginning at 40% on January 1, 2015 and an additional 20% per year thereafter). Under the Basel III Capital Rules, the effects of certain accumulated other comprehensive income or loss items are not excluded for the purposes of determining regulatory capital ratios; however, non-advanced approaches banking organizations (i.e., banking organizations with less than $250 billion in total consolidated assets or with less than $10 billion of on-balance sheet foreign exposures), including the Company and the Bank, may make a one-time permanent election to exclude these items. The Company and the Bank made this election in the first quarter of 2015’s call reports in order to avoid significant variations in the level of capital depending upon the impact of interest rate fluctuations on the fair value of its available-for-sale investment securities portfolio.

The Basel III Capital Rules prescribe a new standardized approach for risk weightings that expands the risk weighting categories from the previous four Basel I-derived categories (0%, 20%, 50% and 100%) to a larger and more risk-sensitive number of categories, generally ranging from 0% for U.S. Government and agency securities, to 600% for certain equity exposures, depending on the nature of the assets. The new capital rules generally result in higher risk weights for a variety of asset classes. Additional aspects of the Basel III Capital Rules that are relevant to the Company and the Bank include:

- consistent with the Basel I risk-based capital rules, assigning exposures secured by single-family residential properties to either a 50% risk weight for first-lien mortgages that meet prudent underwriting standards or a 100% risk weight category for all other mortgages;

- providing for a 20% credit conversion factor for the unused portion of a commitment with an original maturity of one year or less that is not unconditionally cancellable (set at 0% under the Basel I risk-based capital rules);

- assigning a 150% risk weight to all exposures that are nonaccrual or 90 days or more past due (set at 100% under the Basel I risk-based capital rules), except for those secured by single-family residential properties, which will be assigned a 100% risk weight, consistent with the Basel I risk-based capital rules;

- applying a 150% risk weight instead of a 100% risk weight for certain high volatility commercial real estate acquisition, development and construction loans; and

- applying a 250% risk weight to the portion of mortgage servicing rights and deferred tax assets arising from temporary differences that could not be realized through net operating loss carrybacks that are not deducted from CET1 capital (set at 100% under the Basel I risk-based capital rules).

As of December 31, 2018, the Company’s and the Bank’s capital ratios exceeded the minimum capital adequacy guideline percentage requirements of the federal banking agencies for “well capitalized” institutions under the Basel III capital rules on a fully phased-in basis.

With respect to the Bank, the Basel III capital rules also revise the prompt corrective action regulations pursuant to Section 38 of the Federal Deposit Insurance Act.

In December 2017, the Basel Committee published standards that it described as the finalization of the Basel III post-crisis regulatory reforms, which standards are commonly referred to as Basel IV. Among other things, these standards revise the Basel Committee’s standardized approach for credit risk (including the recalibration of the risk weights and the introduction of new capital requirements for certain "unconditionally cancellable commitments," such as unused credit card lines of credit) and provides a new standardized approach for operational risk capital. Under the Basel framework, these standards will generally be effective on January 1, 2022, with an aggregate output floor phasing in through January 1, 2027. Under the current U.S. capital rules, operational risk capital requirements and a capital floor apply only to advanced approaches institutions, and not to the Bank. The impact of Basel IV on us will depend on how it is implemented by the federal bank regulators.

Table of Contents
Prompt Corrective Action ("PCA")

The Federal Deposit Insurance Act, as amended ("FDIA"), requires federal banking agencies to take PCA in respect of depository institutions that do not meet minimum capital requirements. The FDIA includes the following five capital tiers: "well capitalized," "adequately capitalized," "undercapitalized," "significantly undercapitalized," and "critically undercapitalized." A depository institution's capital tier will depend upon how its capital levels compare with various relevant capital measures and certain other factors, as established by regulation. The Basel III Capital Rules revised the PCA requirements effective January 1, 2015. Under the revised PCA provisions of the FDIA, an insured depository institution generally will be classified in the following categories based on the capital measures indicated:

Capital Category	Total Risk-Based Capital Ratio	Tier 1 Risk-Based Capital Ratio	Common Equity Tier 1 (CET1) Capital Ratio	Leverage Ratio	Tangible Equity to Assets	Supplemental Leverage Ratio
Well Capitalized	10% or greater	8% or greater	6.5% or greater	5% or greater	n/a	n/a
Adequately Capitalized	8% or greater	6% or greater	4.5% or greater	4% or greater	n/a	3% or greater
Undercapitalized	Less than 8%	Less than 6%	Less than 4.5%	Less than 4%	n/a	Less than 3%
Significantly Undercapitalized	Less than 6%	Less than 4%	Less than 3%	Less than 3%	n/a	n/a
Critically Undercapitalized	n/a	n/a	n/a	n/a	Less than 2%	n/a

An institution may be downgraded to, or deemed to be in, a capital category that is lower than indicated by its capital ratios, if it is determined to be in an unsafe or unsound condition or if it receives an unsatisfactory examination rating with respect to certain matters. A bank's capital category is determined solely for the purpose of applying PCA regulations and the capital category may not constitute an accurate representation of the bank's overall financial condition or prospects for other purposes.

The FDIA generally prohibits a depository institution from making any capital distributions (including payment of a dividend) or paying any management fee to its parent holding company, if the depository institution would thereafter be "undercapitalized." "Undercapitalized" institutions are subject to growth limitations and are required to submit capital restoration plans. If a depository institution fails to submit an acceptable plan, it is treated as if it is "significantly undercapitalized." "Significantly undercapitalized" depository institutions may be subject to a number of requirements and restrictions, including orders to sell sufficient voting stock to become "adequately capitalized," requirements to reduce total assets, and cessation of receipt of deposits from correspondent banks. "Critically undercapitalized" institutions are subject to the appointment of a receiver or conservator.

The capital classification of a bank holding company and a bank affects the frequency of regulatory examinations, the bank holding company's and the bank's ability to engage in certain activities and the deposit insurance premium paid by the bank. As of December 31, 2018, we met the requirements to be "well-capitalized" based upon the aforementioned ratios for purposes of the prompt corrective action regulations, as currently in effect.

As directed by the Economic Growth Act, the federal bank agencies have issued a joint proposed rule whereby most qualifying community banking organizations with less than $10 billion in total consolidated assets, that meet risk-based qualifying criteria, and have a community bank leverage ratio ("CBLR") of greater than 9 percent would be able to opt into a new community banking leverage ratio framework. Such a community banking organization would not be subject to other risk-based and leverage capital requirements (including the Basel III and Basel IV requirements) and would be considered to have met the well capitalized ratio requirements. The CBLR is determined by dividing a financial institution's tangible equity capital by its average total consolidated assets. The proposed rule further describes what is included in tangible equity capital and average total consolidated assets. The Bank feels that should this rule be adopted in a substantially similar format to the proposed rule, it would greatly ease the process of determining the Bank's capital requirements.

Table of Contents

The USA Patriot Act

Title III of the United and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (the "Patriot Act") is designed to deny terrorists and criminals the ability to obtain access to the U.S. financial system and has significant implications for depository institutions, brokers, dealers and other businesses involved in the transfer of money. The Patriot Act mandates financial services companies to have policies and procedures with respect to measures designed to address any or all of the following matters: (i) customer identification programs; (ii) money laundering; (iii) terrorist financing; (iv) identifying and reporting suspicious activities and currency transactions; (v) currency crimes; and (vi) cooperation between financial institutions and law enforcement authorities. Regulatory authorities routinely examine financial institutions for compliance with these obligations, and failure of a financial institution to maintain and implement adequate programs to combat money laundering and terrorist financing, or to comply with all of the relevant laws or regulations, could have serious legal and reputational consequences for the institution, including causing applicable bank regulatory authorities not to approve merger or acquisition transactions when regulatory approval is required or to prohibit such transactions even if approval is not required. Regulatory authorities have imposed cease and desist orders and civil money penalties against institutions found to be violating these obligations.

Treasury's Office of Foreign Assets Control ("OFAC"), administers and enforces economic and trade sanctions against targeted foreign countries and regimes under authority of various laws, including designated foreign countries, nationals and others. OFAC publishes lists of specially designated targets and countries. Financial institutions are responsible for, among other things, blocking accounts of and transactions with such targets and countries, prohibiting unlicensed trade and financial transactions with them and reporting blocked transactions after their occurrence. Banking regulators examine banks for compliance with the economic sanctions regulations administered by OFAC and failure of a financial institution to maintain and implement adequate OFAC programs, or to comply with all of the relevant laws or regulations, could have serious legal and reputational consequences for the institution.

Privacy Restrictions

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

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

Dividends and Other Transfer of Funds

Dividends from the Bank constitute the principal source of cash 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 $38.4 million at December 31, 2018. During 2018, the Bank paid $73.0 million in dividends to the Company.

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

Table of Contents

Transactions with Affiliates

The Bank is subject to certain restrictions imposed by federal law on any extensions of credit to, or the issuance of a guarantee or letter of credit on behalf of the Company or other affiliates, the purchase of, or investments in stock or other securities thereof, the taking of such securities as collateral for loans & leases, and the purchase of assets of the Company or other affiliates. Such restrictions prevent the Company and other affiliates from borrowing from the Bank unless the loans are secured by marketable obligations of designated amounts. Further, such secured loans and investments by the Bank to or in the Company or to or in any other affiliates are limited, individually, to 10% of the Bank's capital and surplus (as defined by federal regulations), and such secured loans and investments are limited, in the aggregate, to 20% of the Bank's capital and surplus (as defined by federal regulations).

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."

Safety and Soundness Standards

The federal banking agencies have adopted guidelines that establish operational and managerial standards to promote the safety and soundness of federally insured depository institutions. The guidelines set forth standards for internal controls, information systems, internal audit systems, loan documentation, credit underwriting, interest rate exposure, asset growth, compensation, fees and benefits, asset quality and earnings.

In general, the safety and soundness guidelines prescribe the goals to be achieved in each area, and each institution is responsible for establishing its own procedures to achieve those goals. If an institution fails to comply with any of the standards set forth in the guidelines, the financial institution's primary federal regulator may require the institution to submit a plan for achieving and maintaining compliance. If a financial institution fails to submit an acceptable compliance plan, or fails in any material respect to implement a compliance plan that has been accepted by its primary federal regulator, the regulator is required to issue an order directing the institution to cure the deficiency. Until the deficiency cited in the regulator's order is cured, the regulator may restrict the financial institution's rate of growth, require the financial institution to increase its capital, restrict the rates the institution pays on deposits or require the institution to take any action the regulator deems appropriate under the circumstances. Noncompliance with the standards established by the safety and soundness guidelines may also constitute grounds for other enforcement action by the federal bank regulatory agencies, including cease and desist orders and civil money penalty assessments.

During the past decade, the bank regulatory agencies have increasingly emphasized the importance of sound risk management processes and strong internal controls when evaluating the activities of the financial institutions they supervise. Properly managing risks has been identified as critical to the conduct of safe and sound banking activities and has become even more important as new technologies, product innovation, and the size and speed of financial transactions have changed the nature of banking markets. The agencies have identified a spectrum of risks facing a banking institution including, but not limited to, credit, market, liquidity, operational, legal, and reputational risk. In particular, recent regulatory pronouncements have focused on operational risk, which arises from the potential that inadequate information systems, operational problems, breaches in internal controls, fraud, or unforeseen catastrophes will result in unexpected losses. New products and services, third-party risk management and cyber-security are critical sources of operational risk that financial institutions are expected to address in the current environment. The Bank is expected to have active board and senior management oversight; adequate policies, procedures, and limits; adequate risk measurement, monitoring, and management information systems; and comprehensive internal controls.

Table of Contents

Deposit Insurance

As an FDIC-insured institution, the Bank is required to pay deposit insurance premium assessments to the FDIC. The premiums fund the deposit insurance fund. The FDIC assesses a quarterly deposit insurance premium on each insured institution based on risk characteristics of the institution and may also impose special assessments in emergency situations. Effective July 1, 2016, the FDIC changed the deposit insurance assessment system for banks, such as the Bank, with less than $10 billion in assets that have been federally insured for at least five years. Among other changes, the FDIC eliminated risk categories for such banks and now uses the "financial ratios method" to determine assessment rates for all such banks. Under the financial ratios method, the FDIC determines assessment rates based on a combination of financial data and supervisory ratings that estimate a bank's probability of failure within three years. The assessment rate determined by considering such information is then applied to the amount of the institution's average assets minus average tangible equity to determine the institution's insurance premium.

The Dodd-Frank Act requires the FDIC to ensure that the DIF reserve ratio, which is the amount in the DIF as a percentage of all DIF-insured deposits, reaches 1.35% by September 3, 2020. The Dodd-Frank Act also altered the minimum designated reserve ratio for the DIF, increasing the minimum from 1.15% to 1.35%, and eliminated the requirement that the FDIC pay dividends to depository institutions when the reserve ratio exceeds certain thresholds. At least semi-annually, the FDIC updates its loss and income projections for the DIF and, if needed, may increase or decrease the assessment rates, following notice and comment on proposed rulemaking if required. As a result, the Bank's FDIC deposit insurance premiums could increase.

The Bank's FDIC premiums were $912,000 in 2018 and $932,000 in 2017. 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 August 2016 and the Bank received an overall Outstanding rating in complying with its CRA obligations.

Consumer Protection Regulations

Banks and other financial institutions are subject to numerous laws and regulations intended to protect consumers in their transactions with banks. These laws include, among others, laws regarding unfair and deceptive acts and practices and usury laws, as well as the following consumer protection statutes: Truth in Lending Act, Truth in

Savings Act, Electronic Fund Transfer Act, Expedited Funds Availability Act, Equal Credit Opportunity Act, Fair and Accurate Credit Transactions Act, Fair Housing Act, Fair Credit Reporting Act, Fair Debt Collection Practices Act, Gramm-Leach-Bliley Act, Home Mortgage Disclosure Act, Right to Financial Privacy Act, Servicemembers Civil Relief Act, Military Lending Act and Real Estate Settlement Procedures Act.

Table of Contents
Many states and local jurisdictions have consumer protection laws analogous, and in addition, to those listed above. These federal, state and local laws regulate the manner in which financial institutions deal with customers when taking deposits, making loans or conducting other types of transactions. Failure to comply with these laws and regulations could give rise to regulatory sanctions, customer rescission rights, action by state and local attorneys general and civil or criminal liability. Failure to comply with consumer protection requirements may also result in our failure to obtain any required bank regulatory approval for merger or acquisition transactions we may wish to pursue or our prohibition from engaging in such transactions even if approval is not required.

The structure of federal consumer protection regulation applicable to all providers of consumer financial products and services changed significantly on July 21, 2011, when the CFPB commenced operations to supervise and enforce consumer protection laws. The consumer protection provisions of the Dodd-Frank Act and the examination, supervision and enforcement of those laws and implementing regulations by the CFPB have created a more intense and complex environment for consumer finance regulation. The CFPB has significant authority to implement and enforce federal consumer protection laws and new requirements for financial services products provided for in the Dodd-Frank Act, as well as the authority to identify and prohibit unfair, deceptive or abusive acts and practices. The review of products and practices to prevent such acts and practices is a continuing focus of the CFPB, and of banking regulators more broadly. The ultimate impact of this heightened scrutiny is uncertain but could result in changes to pricing, practices, products and procedures. It could also result in increased costs related to regulatory oversight, supervision and examination, additional remediation efforts and possible penalties. In addition, the Dodd-Frank Act provides the CFPB with broad supervisory, examination and enforcement authority over various consumer financial products and services, including the ability to require reimbursements and other payments to customers for alleged legal violations and to impose significant penalties, as well as injunctive relief that prohibits lenders from engaging in allegedly unlawful practices. The CFPB also has the authority to obtain cease and desist orders providing for affirmative relief or monetary penalties. The Dodd-Frank Act does not prevent states from adopting stricter consumer protection standards. State regulation of financial products and potential enforcement actions could also adversely affect our business, financial condition or results of operations.

The CFPB is authorized to issue rules for both bank and nonbank companies that offer consumer financial products and services, subject to consultation with the prudential banking regulators. In general, however, banks with assets of $10 billion or less, such as the Bank, will continue to be examined for consumer compliance by their primary bank regulator.

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

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

- control of any other bank or bank holding company or all or substantially all the assets thereof; or

- more than 5% of the voting shares of a bank or bank holding company which is not already a subsidiary.

Table of Contents

Incentive Compensation

In 2010, the federal bank regulatory agencies issued comprehensive guidance intended to ensure that the incentive compensation policies of banking organizations do not undermine the safety and soundness of those organizations by encouraging excessive risk-taking. The incentive compensation guidance sets expectations for banking organizations concerning their incentive compensation arrangements and related risk-management, control and governance processes. The incentive compensation guidance, which covers all employees that have the ability to materially affect the risk profile of an organization, either individually or as part of a group, is based upon three primary principles: (1) balanced risk-taking incentives; (2) compatibility with effective controls and risk management; and (3) strong corporate governance. Any deficiencies in compensation practices that are identified may be incorporated into the organization's supervisory ratings, which can affect its ability to make acquisitions or take other actions. In addition, under the incentive compensation guidance, a banking organization's federal supervisor may initiate enforcement action if the organization's incentive compensation arrangements pose a risk to the safety and soundness of the organization.

In 2016, several federal financial agencies (including the FRB and FDIC) re-proposed restrictions on incentive-based compensation pursuant to Section 956 of the Dodd-Frank Act for financial institutions with $1 billion or more in total consolidated assets. For institutions with at least $1 billion but less than $50 billion in total consolidated assets, the proposal would impose principles-based restrictions that are broadly consistent with existing interagency guidance on incentive-based compensation. Such institutions would be prohibited from entering into incentive compensation arrangements that encourage inappropriate risks by the institution (i) by providing an executive officer, employee, director, or principal shareholder with excessive compensation, fees, or benefits, or (ii) that could lead to material financial loss to the institution. The comment period for these proposed regulations has closed, but a final rule has not been published. Depending upon the outcome of the rule making process, the application of this rule to us could require us to revise our compensation strategy, increase our administrative costs and adversely affect our ability to recruit and retain qualified employees. Further, as discussed above, the Basel III Capital Rules limit discretionary bonus payments to bank executives if the institution's regulatory capital ratios fail to exceed certain thresholds that started being phased in on January 1, 2016.

Available Information

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

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

Economic Conditions Nationally And In Our Service Areas Could Adversely Affect Our Operations And/Or Cause Us To Sustain Losses - The national economy and the economy of other portions of California have, for the most part, experienced solid improvements over the past several years. However, the economy of the Central Valley of California, which remains the Company’s primary market area, despite having improved, continues to experience challenges. This is reflected in:

Table of Contents

- continuing public sector financial stress, both at the local and statewide level. See “Item 1. Business – Service Area.” For example, the State of California, a large employer in one of the Company’s market territories, continues to experience financial challenges, particularly relating to the funding of pension and other financial commitments made to retired employees, and the City of Stockton, which exited bankruptcy in February, 2015 but still faces financial challenges; and
- levels of unemployment that remain above statewide and nationwide averages and home prices that have improved but remain below peak levels in many market segments.

Although we have initiated efforts to broaden our geographic footprint, our retail and commercial banking operations remain concentrated in Sacramento, San Joaquin, Stanislaus and Merced Counties. See “Item 1. Business – Service Area.” As a result of this geographic concentration, our results of operations depend largely upon economic conditions in these areas. Whereas much of this area has improved, real estate values remain below peak prices and unemployment remains above most other areas in the state and country. As a result, risk still remains from the possibility that losses will be sustained if a significant number of our borrowers, guarantors and related parties fail to perform in accordance with the terms of their loans or leases. We have adopted underwriting and credit monitoring procedures and credit policies, including the establishment and review of the allowance for credit losses, that management believes are appropriate to minimize this risk by assessing the likelihood of nonperformance, tracking loan & lease performance and diversifying our credit portfolio. These policies and procedures; however, may not prevent unexpected losses that could materially adversely affect our results of operations in general and the market value of our stock. See “Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations – Overview - Looking Forward: 2019 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 still not fully known at this time. Such events may have a negative effect on: (i) our ability to service our existing customers and attract new customers; (ii) the ability of our borrowers to operate their business as successfully as in the past; (iii) the financial security and net worth of our customers; and (iv) the ability of our customers to repay their loans or leases with us in accordance with the terms thereof.

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

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

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

Table of Contents

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

In June 2016, the Financial Accounting Standards Board (“FASB”) issued an Accounting Standards Update, Financial Instruments: Credit Losses (“CECL”), which establishes a new impairment framework also known as the “current expected credit loss model.” In contrast to the incurred loss model currently used by financial entities like us, the current expected credit loss model requires an allowance be recognized based on the expected credit losses (i.e. all contractual cash flows that the entity does not expect to collect from financial assets or commitments to extend credit). It requires the consideration of more forward-looking information than is permitted under current U.S. generally accepted accounting principles. In addition to relevant information about past events and current conditions, such as borrowers’ current creditworthiness, quantitative and qualitative factors specific to borrowers, and the economic environment in which the entity operates, the new model requires consideration of reasonable and supportable forecasts that affect the expected collectability of the financial assets’ remaining contractual cash flows, and evaluation of the forecasted direction of the economic cycle, as well as time value of money. This proposed impairment framework is expected to have wide reaching implications to financial institutions such as us. The CECL model will become effective for the Bank for the fiscal year beginning after December 15, 2019. See Note 20, located in “Item 8. Financial Statements and Supplementary Data.”

We Are Dependent On Real Estate And Downturns In The Real Estate Market Could Hurt Our Business - A significant portion of our loan portfolio is dependent on real estate. See “Item 1. Business – Supervision and Regulation - Prompt Corrective Action.” At December 31, 2018, real estate served as the principal source of collateral with respect to approximately 70% of our loans outstanding. Stresses in economic conditions in our local markets or rising interest rates could have an adverse effect on the demand for new loans, the ability of borrowers to repay outstanding loans, the value of real estate and other collateral securing loans and the value of real estate owned by us, as well as our financial condition and results of operations in general and the market value of our common stock.

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

Our Real Estate Lending Also Exposes Us To The Risk Of Environmental Liabilities - In the course of our business, we may foreclose and take title to real estate, and could be subject to environmental liabilities with respect to these properties. We may be held liable to a governmental entity or to third persons for property damage, personal injury, investigation and clean-up costs incurred by these parties in connection with environmental contamination, or may be required to investigate or clean up hazardous or toxic substances, or chemical releases at a property. The costs associated with investigation or remediation activities could be substantial. In addition, as the owner or former owner of a contaminated site, we may be subject to common law claims by third parties based on damages and costs resulting from environmental contamination emanating from the property. If we ever become subject to significant environmental liabilities, our business, financial condition, liquidity and results of operations could be materially and adversely affected.

Our Business Is Subject To Interest Rate Risk And Changes In Interest Rates May Adversely Affect Our Performance And Financial Condition - Our earnings are impacted by changing interest rates. Changes in interest rates impact the demand for new loans & leases, the credit profile of our borrowers, the rates received on loans & leases and securities and rates paid on deposits and borrowings. The difference between the rates received on loans & leases and securities and the rates paid on deposits and borrowings is known as the net interest margin. Like many financial institutions, our net interest margin has improved over the past year as a result of the FRB increasing short-term interest rates by 2.25% since December 2015. However, looking forward, even if short-term rates continue to rise, aggressive competitor pricing strategies, particularly for deposits, could adversely impact our net interest margin in 2019.

Future levels of market interest rates could adversely affect our earnings. Despite the FRB increasing short-term interest rates by 2.25% since December 2015 they remain at relatively low levels. Our CRE and commercial loans carry interest rates that, in general, adjust in accordance with changes in the prime rate. We are also significantly affected by the level of loan & lease demand available in our market. The inability to make sufficient loans & leases directly affects the interest income we earn. Lower loan & lease demand will generally result in lower interest income realized as we place funds in lower yielding investments. See "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations – Overview - Looking Forward: 2019 and Beyond."

Table of Contents

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."

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

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

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

Growth May Produce Unfavorable Outcomes - We seek to expand our franchise safely and consistently. A successful growth strategy requires us to manage multiple aspects of the business simultaneously, such as following adequate loan underwriting standards, balancing loan and deposit growth without increasing interest rate risk or compressing our net interest margin, maintaining sufficient capital, and recruiting, training and retaining qualified professionals.

Our growth strategy also includes acquisition possibilities (such as Delta National Bancorp & Bank of Rio Vista) that either enhance our market presence or have potential for improved profitability through financial management, economies of scale or expanded services. We may be exposed to difficulties in combining the operations of acquired institutions into our own operations, which may prevent us from achieving the expected benefits from our acquisition activities. Inherent uncertainties exist in integrating the operations of an acquired institution and there is no assurance that we will be able to do so successfully. Among the issues that we could face are:

- unexpected problems with operations, personnel, technology or credit;

- loss of customers and employees of the acquiree;

- difficulty in working with the acquiree's employees and customers;

Table of Contents

- the assimilation of the acquiree’s operations, culture and personnel;

- instituting and maintaining uniform standards, controls, procedures and policies; and

- litigation risk not discovered during the due diligence period.

Undiscovered factors as a result of an acquisition could bring liabilities against us, our management and the management of the institutions we acquire. These factors could contribute to our not achieving the expected benefits from our acquisitions within desired time frames, if at all. Further, although we anticipate cost savings as a result of mergers, we may not be able to fully realize those savings. Any cost savings that are realized may be offset by losses in revenues or other charges to earnings.

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

Our Financial Results Can Be Impacted By The Cyclicality and Seasonality Of Our Agricultural Business And The Risks Related Thereto - The Company has provided financing to agricultural customers in the Central Valley throughout its history. We recognize the cyclical nature of the industry, often caused by fluctuating commodity prices, changing climatic conditions and the availability of seasonal labor, and manage these risks accordingly. The Company remains committed to providing credit to agricultural customers and will always have a material exposure to this industry. Although the Company’s loan portfolio is believed to be well diversified, at various times during 2018 approximately 36% of the Company’s loan balances were outstanding to agricultural borrowers. Commitments are well diversified across various commodities, including dairy, grapes, walnuts, almonds, cherries, apples, pears, and various row crops. Additionally, many individual borrowers are themselves diversified across commodity types, reducing their exposure, and therefore the Company’s, to cyclical downturns in any one commodity.

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

The Impact of Climate and Government on The Availability of Water is a Long Term Risk That Could Affect Our Customers’ Businesses - The State of California experienced drought conditions from 2013 through most of 2016. Since 2016, reasonable levels of rain and snow have alleviated drought conditions in many areas of California, including those in the Company’s primary service area. As a result, reservoir levels are high and the availability of water in our primary service area should not be an issue. However, the weather patterns over the past 5 years further reinforce the fact that the long-term risks associated with the availability of water are significant.

The farming belt of the Central Valley was often cited as an example of an area that experienced extreme drought during 2013 - 2016. However, it is important to understand that not all areas of the state were impacted equally, and this is particularly true in the Central Valley, which stretches some 450 miles from Bakersfield in the south to Redding in the north. The vast majority of the Company's agricultural customers are located in the more northern portion of the Central Valley, an area that benefits from the drainage of the Sacramento, American, Mokelumne and Stanislaus rivers. As a result, even during the worst of the drought farmers in this area still had access to reasonable ground water sources that were economical to pump.

Table of Contents

Importantly, the Company has minimal credit exposure in the more southern portion of the Central Valley, defined broadly as an area south of Highway 152, but more importantly the Fresno area and south (including the Westlands Water District). In most of these areas ground water levels were depleted, making farmers increasingly dependent on the delivery of surface water from the Central Valley Project, which cut back deliveries to many farmers during the worst of the drought.

In addition to the impact of climate on the availability of water, the "politics" of water, and how the state and federal governments ultimately manage this resource, could also impact how much water our customers have access to. For example:

- Many of our agricultural customers have senior riparian water rights, which provide them the legal right to access surface water from the rivers that abut their property. In the spring of 2015, the State of California took the extreme step of threatening to curtail certain riparian water rights for those farmers taking water from the Delta, and as a result affected growers agreed to voluntarily cutback 25% of their normal water usage as opposed to undertaking a protracted legal fight. Even with these cutbacks, our agricultural customers still had access to sufficient levels of water to satisfy their needs.

- In 2014, the State of California passed the Sustainable Groundwater Management Act. All Water Districts must develop plans to comply with the Act, including groundwater recharge programs. Although the exact impact of compliance is not currently known, and even prior to 2014 most of the Water Districts in the Bank's service area had been developing and implementing management plans, it is possible that some Water Districts will have to ultimately fallow some ground to achieve compliance with the Act.

These situations point out how the "politics" of water can also affect the availability of water.

The Company monitors the water situation through: (i) regularly reviewing ground water level reports provided by California's Department of Water Resources; (ii) requiring water budgets and plans from all of our agricultural borrowers that detail the sources of their irrigation water and the irrigation requirements to achieve their crop plan; and (iii) in the case of new permanent crop development projects, requiring well tests.

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

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

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

Table of Contents
Deposit Insurance Assessments Could Increase At Any Time, Which Will Adversely Affect Profits - FDIC deposit insurance expense for the years 2018, 2017, and 2016 was $912,000, $932,000, and $1.17 million, respectively. During 2011, the FDIC changed its methodology for calculating deposit premiums, See “Item 1. Business – Supervision and Regulation – Deposit Insurance.” Any increases could have adverse effects on the operating expenses and results of operations of the Company.

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

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

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

The financial services industry is continually undergoing rapid technological change with frequent introductions of new technology-driven products and services. The effective use of technology increases efficiency and enables financial institutions to better serve customers and to reduce costs. Our future success depends, in part, upon our ability to address the needs of our customers by using technology to provide products and services that will satisfy customer demands, as well as to create additional efficiencies in our operations. Many of our competitors have substantially greater resources to invest in technological improvements. We may not be able to effectively implement new technology-driven products and services or be successful in marketing these products and services to our customers. Failure to successfully keep pace with technological change affecting the financial services industry could have a material adverse impact on our business and, in turn, our financial condition and results of operations.

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

Table of Contents

The Value of Goodwill and Other Intangible Assets May Decline in the Future - As of December 31, 2018, we had goodwill totaling $11.2 million and a core deposit intangible asset totaling $5.3 million from business acquisitions. A significant decline in expected future cash flows, a significant adverse change in the business climate, slower growth rates or a significant and sustained decline in the price of our common stock could necessitate taking charges in the future related to the impairment of goodwill or other intangible assets. If we were to conclude that a future write-down of goodwill or other intangible assets is necessary, we would record the appropriate charge, which could have a material adverse effect on our business, financial condition and results of operations.

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

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

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

As of December 31, 2018, approximately $1.6 billion, or 52.2%, of our deposits consisted of interest-bearing demand deposits, savings and money market accounts. Based on past experience, we believe that our deposit accounts are relatively stable sources of funds. If we increase interest rates paid to retain deposits, our earnings may be adversely affected, which could have an adverse effect on our business, financial condition and results of operations. Any decline in available funding could adversely impact our ability to originate loans, invest in securities, meet our expenses, pay dividends to our stockholders or to fulfill obligations such as repaying our borrowings or meeting deposit withdrawal demands, any of which could have a material adverse impact on our liquidity, business, financial condition and results of operations.

System failure or breaches of our network security could subject us to increased operating costs as well as litigation and other liabilities - The computer systems and network infrastructure we use could be vulnerable to hardware and cyber-security issues. Our operations are dependent upon our ability to protect our computer equipment against damage from fire, power loss, telecommunications failure or a similar catastrophic event. We could also experience a breach by intentional or negligent conduct on the part of employees or other internal or external sources, including our third-party vendors. Any damage or failure that causes an interruption in our operations could have an adverse effect on our financial condition and results of operations. In addition, our operations are dependent upon our ability to protect the computer systems and network infrastructure utilized by us, including our internet banking activities, against damage from physical break-ins, cyber-security breaches and other disruptive problems caused by the internet or other users. Such computer break-ins and other disruptions would jeopardize the security of information stored in and transmitted through our computer systems and network infrastructure, which may result in significant liability, damage our reputation and inhibit the use of our internet banking services by current and potential customers.

Table of Contents

We rely heavily on communications, information systems (both internal and provided by third-parties) and the internet to conduct our business. Our business is dependent on our ability to process and monitor large numbers of daily transactions in compliance with legal, regulatory and internal standards and specifications. In addition, a significant portion of our operations relies heavily on the secure processing, storage and transmission of personal and confidential information, such as the personal information of our customers and clients. In recent periods, several governmental agencies and large corporations, including financial service organizations and retail companies, have suffered major data breaches, in some cases exposing not only their confidential and proprietary corporate information, but also sensitive financial and other personal information of their clients and their employees or other third-parties, and subjecting those agencies and corporations to potential fraudulent activity and their clients and other third-parties to identity theft and fraudulent activity in their credit card and banking accounts. Therefore, security breaches and cyber-attacks can cause significant increases in operating costs, including the costs of compensating clients and customers for any resulting losses they may incur and the costs and capital expenditures required to correct the deficiencies in and strengthen the security of data processing and storage systems. These risks may increase in the future as we continue to increase mobile payments and other internet-based product offerings and expand our internal usage of web-based products and applications.

In addition to well-known risks related to fraudulent activity, which take many forms, such as check “kiting” or fraud, wire fraud, and other dishonest acts, information security breaches and cyber-security related incidents have become a material risk in the financial services industry. For example, several U.S. financial institutions have recently experienced significant distributed denial-of-service attacks, some of which involved sophisticated and targeted attacks intended to disable or degrade service, or sabotage systems. Other potential attacks have attempted to obtain unauthorized access to confidential information, steal money, or manipulate or destroy data, often through the introduction of computer viruses or malware, cyber-attacks and other means. Other threats of this type may include fraudulent or unauthorized access to data processing or data storage systems used by us or by our clients, electronic identity theft, “phishing,” account takeover, and malware or other cyber-attacks. To date, none of these types of attacks have had a material effect on our business or operations. Such security attacks can originate from a wide variety of sources, including persons who are involved with organized crime or who may be linked to terrorist organizations or hostile foreign governments. Those same parties may also attempt to fraudulently induce employees, customers or other users of our systems to disclose sensitive information in order to gain access to our data or that of our customers or clients.

We are also subject to the risk that our employees may intercept and transmit unauthorized confidential or proprietary information. An interception, misuse or mishandling of personal, confidential or proprietary information being sent to or received from a customer or third-party could result in legal liabilities, remediation costs, regulatory actions and reputational harm.

Unfortunately, it is not always possible to anticipate, detect, or recognize these threats to our systems, or to implement effective preventative measures against all breaches, whether those breaches are malicious or accidental. Cyber-security risks for banking organizations have significantly increased in recent years and have been difficult to detect before they occur because of the following, among other reasons:

- the proliferation of new technologies, and the use of the Internet and telecommunications technologies to conduct financial transactions;
- these threats arise from numerous sources, not all of which are in our control, including among others human error, fraud or malice on the part of employees or third-parties, accidental technological failure, electrical or telecommunication outages, failures of computer servers or other damage to our property or assets, natural disasters or severe weather conditions, or terrorist acts;
-

the techniques used in cyber-attacks change frequently and may not be recognized until launched or until well after the breach has occurred;

- the increased sophistication and activities of organized crime groups, hackers, terrorist organizations, hostile foreign governments, disgruntled employees or vendors, activists and other external parties, including those involved in corporate espionage;

Table of Contents

- the vulnerability of systems to third-parties seeking to gain access to such systems either directly or using equipment or security passwords belonging to employees, customers, third-party service providers or other users of our systems; and
- our frequent transmission of sensitive information to, and storage of such information by, third-parties, including our vendors and regulators, and possible weaknesses that go undetected in our data systems notwithstanding the testing we conduct of those systems.

Our investments in systems and processes that are designed to detect and prevent security breaches and cyber-attacks and our conduct of periodic tests of our security systems and processes, may not succeed in anticipating or adequately protecting against or preventing all security breaches and cyber-attacks from occurring. Even the most advanced internal control environment may be vulnerable to compromise. Targeted social engineering attacks are becoming more sophisticated and are extremely difficult to prevent. Additionally, the existence of cyber-attacks or security breaches at third-parties with access to our data, such as vendors, may not be disclosed to us in a timely manner. As cyber-threats continue to evolve, we may be required to expend significant additional resources to continue to modify or enhance our protective measures or to investigate and remediate any information security vulnerabilities or incidents. We maintain a system of internal controls and insurance coverage to mitigate against operational risks, including data processing system failures and errors and customer or employee fraud. If our internal controls fail to prevent or detect an occurrence, or if any resulting loss is not insured or exceeds applicable insurance limits, it could have a material adverse effect on our business, financial condition and results of operations.

As is the case with non-electronic fraudulent activity, cyber-attacks or other information or security breaches, whether directed at us or third-parties, may result in a material loss or have material consequences. Furthermore, the public perception that a cyber-attack on our systems has been successful, whether or not this perception is correct, may damage our reputation with customers and third-parties with whom we do business. A successful penetration or circumvention of system security could cause us negative consequences, including loss of customers and business opportunities, disruption to our operations and business, misappropriation or destruction of our confidential information and/or that of our customers, or damage to our customers' and/or third-parties' computers or systems, and could expose us to additional regulatory scrutiny and result in a violation of applicable privacy laws and other laws, litigation exposure, regulatory fines, penalties or intervention, loss of confidence in our security measures, reputational damage, reimbursement or other compensatory costs, additional compliance costs, and could adversely impact our results of operations, liquidity and financial condition.

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

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

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

Table of Contents

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

Risks Associated With Our Industry

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

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

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

Risks Associated With Our Stock

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

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

- actual or anticipated variations in quarterly results of operations;

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

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

- available investment liquidity in our market area since our stock is not listed on any exchange; and

- perceptions in the marketplace regarding our Company and/or its competitors.

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.

Table of Contents

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-nine branches in the Company's service area. Of the twenty-nine branches, nineteen are owned and ten are leased. The expiration of these leases occurs between the years 2020 and 2028. See Note 19, located in "Item 8. Financial Statements and Supplementary Data."

Item 3. Legal Proceedings

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

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

Item 4. Mine Safety Disclosures

Not Applicable

PART II

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

The common stock of Farmers & Merchants Bancorp is not widely held or listed on any exchange. However, trades are reported on the OTCQX 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 2017. These figures are based on activity posted on the OTCQX and on private transactions between individual stockholders that are reported to the Company. Since there is limited trading in our stock, (See "Item 1A. Risk Factors – Risks Associated With Our Stock") the "Close" sale prices represent the volume weighted average close prices for the last month of the quarter.

	Calendar Quarter	High	Low	Close	Cash Dividends Declared (Per Share)
2018	Fourth quarter	$725	$665	$700	$ 7.00
	Third quarter	735	650	719	-
	Second quarter	727	650	712	6.90
	First quarter	679	641	645	-

Calendar Quarter	High	Low	Close	Cash Dividends Declared (Per Share)

2017	Fourth quarter	$689	$635	$676	$ 6.80
	Third quarter	645	605	639	-
	Second quarter	630	595	620	6.75
	First quarter	640	595	605	-

28

Table of Contents

As of January 31, 2019, there were approximately 1,648 stockholders of record of the Company's common stock. However, since approximately 15% of our common stock shares are held by brokers on behalf of stockholders, we are unable to determine the exact total number of stockholders.

The Company and, before the Company was formed, the Bank, has paid cash dividends for the past 84 consecutive years. There are limitations under Delaware corporate law as to the amounts of cash dividends that may be paid by the Company. Additionally, if we decided to defer interest on our 2003 subordinated debentures, we would be prohibited from paying cash dividends on the Company's common stock. The Company is dependent on cash dividends paid by the Bank to fund its cash dividend payments to its stockholders. There are regulatory limitations on cash dividends that may be paid by the Bank. 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 November 6, 2018, the Board of Directors approved an extension of the $20 million stock repurchase program over the three-year period ending December 31, 2021.

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

There were no stock repurchases in 2018 or 2017 under the Stock Repurchase Plan. However, in the third quarter of 2018 the Company did repurchase $31.2 million of shares, at $700 per share, in a single transaction from the estate of a large shareholder. The remaining dollar value of shares that may yet be purchased under the Company's Common Stock Repurchase Plan is approximately $20 million.

On May 24, 2018 stockholders approved a proposal to increase our authorized shares of common stock from 7,500,000 to 40,000,000. In approving this proposal the stockholders also granted the Board discretionary authority (i.e., without further stockholder action) to determine whether to delay the proposed amendment. The Company has no immediate plans to effect the increase in the authorized shares of common stock.

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

The Rights Plan is similar to plans adopted by many other publicly traded companies. The effect of the Rights Plan is to discourage any potential acquirer from triggering the Rights without first convincing the Company's Board of Directors that the proposed acquisition is fair to, and in the best interest of, all of the stockholders of the Company. The provisions of the Plan, if triggered by the Acquiring Person, will substantially dilute the equity and voting interest of any potential acquirer unless the Board of Directors approves of the proposed acquisition (under Article XV of the Company's Certificate of Incorporation, the Board of Directors has the authority to consider any and all factors in determining whether an acquisition is in the best interests of the Company and its stockholders). 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.

Table of Contents

The Rights Plan was set to expire on August 5, 2018. On November 19, 2015, the Board of Directors approved a seven-year extension of the term of the Rights Plan. Pursuant to an Amendment to the Rights Agreement dated February 18, 2016, the term of the Rights Plan was extended from August 5, 2018 to August 5, 2025. The extension of the term of the Rights Plan was intended as a means to continue to guard against abusive takeover tactics and was not in response to any particular proposal. The Board also increased the purchase price under the Rights Plan to $1,600 per one one-hundredth of a preferred share from $1,200, to reflect the increase in the market price of the Company's common stock over the past several years.

During 2018, the Company issued a combined total 13,520 shares of common stock to the Bank's non-qualified defined contribution retirement plans. There were also 2,400 shares issued to individuals during the third quarter of 2018. All of the shares were issued at prices ranging from $635.00 to $690.00 per share based upon valuations completed during the quarter of issuance by a nationally recognized bank consulting and advisory firm and in reliance upon the exemption in Section 4(a)(2) of the Securities Act of 1933, as amended, and the regulations promulgated thereunder. The proceeds were contributed to the Bank as equity capital. See Note 14, located in "Item 8. Financial Statements and Supplementary Data."

During 2017, the Company issued 4,975 shares of common stock, which were contributed to the Bank's non-qualified defined contribution retirement plans. The shares issued had prices ranging from $590 per share to $595 per share. These share prices were based upon valuations completed by a nationally recognized bank consulting and advisory firm and in reliance upon the exemption in Section 4(a)(2) of the Securities Act of 1933, as amended, and the regulations promulgated thereunder. The proceeds from these issuances were contributed to the Bank as equity capital.

Performance Graphs

The following graph compares the Company's cumulative total stockholder return on common stock from December 31, 2013 to December 31, 2018 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, 2013 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 OTCQX and on private transactions between individual stockholders that are reported to the Company. This data was furnished by Zacks SEC Compliance Services Group.

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

Table of Contents

Item 6. Selected Financial Data

(in thousands except per share data)					
Summary of Income:	2018	2017	2016	2015	2014
Total Interest Income	$133,453	$114,612	$99,266	$90,075	$81,521
Total Interest Expense	7,950	6,289	4,196	3,325	2,813
Net Interest Income	125,503	108,323	95,070	86,750	78,708
Provision for Credit Losses	5,533	2,850	6,335	750	1,175
Net Interest Income After Provision for Credit Losses	119,970	105,473	88,735	86,000	77,533
Total Non-Interest Income	15,219	16,762	15,257	14,575	14,329
Total Non-Interest Expense	75,459	67,754	58,172	56,259	51,366
Income Before Income Taxes	59,730	54,481	45,820	44,316	40,496
Provision for Income Taxes	14,203	26,111	16,097	16,924	15,094
Net Income	$45,527	$28,370	$29,723	$27,392	$25,402
Balance Sheet Data:					
Total Assets	$3,434,243	$3,075,452	$2,922,121	$2,615,345	$2,360,551
Loans & Leases	2,571,241	2,215,295	2,177,601	1,996,359	1,712,244
Allowance for Credit Losses	55,266	50,342	47,919	41,523	35,401
Investment Securities	548,962	536,056	506,372	430,533	430,405
Goodwill	11,183	-	-	-	-
Core Deposit Intangible	5,278	836	946	-	-
Deposits	3,062,832	2,723,228	2,581,711	2,277,532	2,064,073
Shareholders' Equity	311,215	299,660	279,981	251,835	233,178
Selected Ratios:					
Return on Average Assets	1.45 %	0.94 %	1.12 %	1.12 %	1.17 %
Return on Average Equity	14.80 %	9.66 %	11.17 %	11.21 %	11.43 %
Return on Average Tangible Equity	14.91 %	9.69 %	11.17 %	11.21 %	11.43 %
Dividend Payout Ratio	24.49 %	38.71 %	35.25 %	37.08 %	39.05 %
Average Loans & Leases to Average Deposits	84.36 %	82.18 %	88.63 %	84.44 %	79.99 %
Average Equity to Average Assets	9.66 %	9.77 %	10.05 %	10.02 %	10.28 %
Period-end Shareholders' Equity to Total Assets	9.06 %	9.74 %	9.58 %	9.63 %	9.88 %
Basic and Diluted Per Share Data:					
Earnings [1]	$56.82	$35.03	$37.44	$34.82	$32.64
Cash Dividends Per Share	$13.90	$13.55	$13.10	$12.90	$12.70
Book Value Per Share at Year End [2]	$397.10	$368.90	$346.80	$318.46	$297.39
Tangible Book Value Per Share at Year End [2]	$376.10	$367.87	$345.63	$318.46	$297.39

(1) Based on the weighted average number of shares outstanding of 801,229, 809,834, 793,970, 786,582, and 778,358 for the years ended December 31, 2018, 2017, 2016, 2015, and 2014, respectively.

(2) Based on the year-end number of shares outstanding of 783,721, 812,304, 807,329, 790,787, and 784,082 for the years ended December 31, 2018, 2017, 2016, 2015, and 2014, respectively.

Table of Contents

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

Overview

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

The Five-Year Period: 2014 through 2018

Through much of 2007 the economy in our primary service area was strong, the stock market rising and individuals and businesses doing well. Then in October 2007 the financial markets started what would become a major adjustment and an economic recession began, the impact of which is still being felt today in the Central Valley of California. The Central Valley was one of the hardest hit areas in the country during the recession. In many areas, housing prices declined as much as 60% and unemployment reached 15% or more. Although the economy has improved throughout most of the Central Valley, in many of the Company’s market segments housing prices remain below peak levels and unemployment levels remain above those in other areas of the state and country.

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

Table of Contents

We used certain non-GAAP financial measures to provide supplemental information regarding our performance in 2017. Income Tax Expense for the year ended 2017 included a one-time, non-cash $6.3 million charge related to the re-measurement of the Company's Deferred Tax Asset ("DTA") as a result of the passage of the Tax Cuts and Jobs Act in 2017. We believed that presenting Adjusted Net Income, excluding the impact of the DTA re-measurement charge, provides additional clarity to the users of financial statements regarding core financial performance and allows for a better year-over-year comparison of trends in core profitability.

(in thousands, except per share data) Financial Performance Indicator	2018	2017	2016	2015	2014
Pre Tax Income	$59,730	$54,481	$45,820	$44,316	$40,496
Income Tax Expense	14,203	26,111	16,097	16,924	15,094
Effect of Income Tax Rate Change DTA Re-measurement	-	(6,300)	-	-	-
Adjusted Income Tax Expense	14,203	19,811	16,097	16,924	15,094
Non-GAAP Adjusted Net Income	45,527	34,670	29,723	27,392	25,402
Effect of Income Tax Rate Change DTA Re-measurement	-	(6,300)	-	-	-
Net Income (See Note 1)	$45,527	$28,370	$29,723	$27,392	$25,402
Total Assets	3,434,243	3,075,452	2,922,121	2,615,345	2,360,551
Total Loans & Leases	2,571,241	2,215,295	2,177,601	1,996,359	1,712,244
Total Deposits	3,062,832	2,723,228	2,581,711	2,277,532	2,064,073
Total Shareholders' Equity	311,215	299,660	279,981	251,835	233,178
Total Risk-Based Capital Ratio	11.40%	13.07%	12.80%	12.23%	12.93%
Non-Performing Loans as a % of Total Loans	0.00%	0.00%	0.14%	0.11%	0.13%
Substandard Loans as a % of Total Loans	0.57%	0.40%	0.29%	0.31%	0.21%
Net Charge-Offs (Recoveries) to Average Loans	0.03%	0.02%	0.00%	(0.30%)	0.00%
Loan Loss Allowance as a % of Total Loans	2.14%	2.27%	2.19%	2.07%	2.06%
Return on Average Assets	1.45%	0.94%	1.12%	1.12%	1.17%
Adjusted Return on Average Assets	1.45%	1.15%	1.12%	1.12%	1.17%
Return on Average Equity	14.80%	9.66%	11.17%	11.21%	11.43%
Adjusted Return on Average Equity	14.80%	11.79%	11.17%	11.21%	11.43%
Earnings Per Share	56.82	35.03	37.44	34.82	32.64
Adjusted Earnings Per Share	56.82	42.81	37.44	34.82	32.64
Cash Dividends Per Share	13.90	13.55	13.10	12.90	12.70
Cash Dividends Declared	11,151	10,982	10,478	10,157	9,919

Note 1 – On December 22, 2017, the Tax Cuts and Jobs Act was signed into law by the President. Among other things, this legislation reduced the corporate tax rate from 35% to 21% beginning January 1, 2018. Although the Company believes that this reduction in the corporate tax rate will continue to have a significant positive impact on future financial performance, U.S. generally accepted accounting principles require that all companies re-measure their DTA's using the new lower tax rate as of the date of enactment of the legislation. As a result the Company's net income for 2017 included a $6.3 million re-measurement reflected as a one-time, non-cash increase to income tax expense in the 4th quarter. Our situation is not unique in that the majority of all financial institutions reported significant DTA re-measurements in the 4th quarter of 2017. Excluding the impact of the $6.3 million DTA re-measurement, non-GAAP adjusted net income for the year totaled $34.6 million, an increase of $5.0 million or 16.8% over the prior year, which would have resulted in an adjusted return on average assets of 1.15% and adjusted return on average equity of 11.79%.

Management believes that the Company's performance compared very favorably to its peer banks during the five-year period ending December 31, 2018:

- Net income over the five-year period totaled $156.4 million.

Table of Contents

- Return on Average Assets averaged 1.16% over the five-year period.

- Total assets increased 65.4% from $2.0 billion at December 31, 2013 to $3.4 billion at December 31, 2018.

- Total loans & leases increased 85.2% from $1.4 billion at December 31, 2013 to $2.6 billion at December 31, 2018.

- Total deposits increased 69.4% from $1.8 billion at December 31, 2013 to $3.1 billion at December 31, 2018.

More recently:

- In 2018, the Company earned $45.5 million for a return on average assets of 1.45%.

- In 2018, the Company increased its cash dividend per share by 2.6% over 2017 levels, and our strong financial performance has allowed us to increase dividends every year during this five-year period.

- The Company's total risk based capital ratio was 11.40% at December 31, 2018, and the Bank achieved the highest regulatory classification of "well capitalized" in each of the previous five years. See "Financial Condition – Capital."

- The Company continued to diversify its geographic footprint by acquiring (1) Delta National Bancorp with branches in Turlock, Manteca and Riverbank; and (2) Bank of Rio Vista with branches in Rio Vista and Walnut Grove.

- The Company's asset quality remains very strong at the present time, when measured by: (1) net charge-offs at 0.03% of average loans & leases during 2018; (2) no non-accrual loans at December 31, 2018; and (3) substandard loans & leases totaling 0.57% of total loans & leases at December 31, 2018. See "Results of Operations – Provision and Allowance for Credit Losses" and "Financial Condition – Classified Loans & Leases and Non-Performing Assets."

Because of this strong earnings performance, capital position, and asset quality, stockholders have benefited from the fact that cash dividends per share have increased 11.2% since 2013, and totaled $66.15 per share over the five-year period. The 2018 dividend of $13.90 per share represents a 2.00% yield based upon the December 31, 2018 closing stock price of $700 per share (See "Part II, Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities").

Looking Forward: 2019 and Beyond

In management's opinion, the following key issues will continue to influence the financial results of the Company in 2019 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.

  - Since December 2015, the FRB has increased short-term market rates by 2.25%. However, market rates remain historically low, and although short-term rates may continue to increase in 2019 Management does not expect them to change significantly.
  - Loans increased $1.2 billion, or 85.2% over the past five years, partially as a result of our expansion into Walnut Creek, Concord and equipment leasing, as well as our acquisitions of Delta Bank and Bank of Rio Vista. However, we still face a very competitive business environment, and no assurances can be given that this recent growth in the loan & lease portfolio will continue.
  - Aggressive competitor pricing for loans, leases and deposits continues to require the Company to respond in order to retain key customers.

34

Table of Contents

As a result of increases in short-term market interest rates, which began in 2015, the Company's net interest margin increased from 3.88% for the year ended December 31, 2014 to 4.25% for the year ended December 31, 2018. Although the increase in short-term market interest rates has helped the Company's loan yields, rising deposit rates and other competitor pricing pressures may adversely affect the net interest margin in 2019. See "Item 7A. Quantitative and Qualitative Disclosures About Market Risk - Interest Rate Risk."

- The Company's results are impacted by changes in the credit quality of its borrowers. Substandard loans & leases totaled $14.7 million or 0.57% of total loans & leases at December 31, 2018 vs. $8.9 million or 0.40% of total loans at December 31, 2017. Management believes, based on information currently available, that these levels are adequately covered by the Company's $55.3 million allowance for credit losses as of December 31, 2018. See "Results of Operations - Provision and Allowance for Credit Losses" and "Financial Condition – Classified Loans & Leases and Non-Performing Assets." The Company's provision for credit losses was $5.5 million in 2018, compared to $2.9 million in 2017 and $6.3 million in 2016. See "Item 1A. Risk Factors."

- FDIC deposit insurance expense for the years 2018, 2017, and 2016 was $912,000, $932,000, and $1.17 million, respectively. In 2011, the FDIC changed its methodology for calculating deposit premiums. See "Item 1. Business – Supervision and Regulation – Deposit Insurance." While FDIC deposit insurance assessments have stabilized in recent years, they remain well above the pre-recession level the Company paid in 2007.

- Since the passage of the Dodd-Frank Act in 2010, Congress has implemented broad changes to the regulation of consumer financial products and the financial services industry as a whole. These changes have, and will continue to have, a significant effect on the Company's product offerings, pricing and profitability in areas such as debit and credit cards, home mortgages and deposit service charges.

- The Company has (i) expanded its geographic footprint through denovo branch expansion in Walnut Creek, Napa and Concord, CA and through acquisition in Manteca, Riverbank, Rio Vista, and Walnut Grove, CA and (ii) established equipment leasing as a new line of business. Although Management believes that these initiatives will result in increased asset growth and earnings, along with reduced concentration risks, the start-up costs related to staff and facilities are significant and will take time to recoup.

- The Company benefited significantly in 2018, and should continue to benefit in future years, from the reduction of the federal corporate tax rate from 35% to 21% pursuant to the recently enacted Tax Cuts and Jobs Act.

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, 2018 and the material changes in financial condition, operating income, and expense of the Company and its subsidiaries as shown in the accompanying financial statements.

Impact of Delta National Bancorp Acquisition on Results of Operations

On November 18, 2016, Farmers & Merchants Bancorp completed the acquisition of Delta National Bancorp. Since the acquisition took place late in the year, and Delta National Bancorp had only $112 million in assets (less than 4% of Farmers & Merchants Bancorp's total assets), the post-acquisition impact on the Company's 2016 Results of Operations was immaterial with the exception of a Bargain Purchase Gain of $1.83 million that was booked as non-interest income and $910,000 in acquisition expenses that were booked as non-interest expense.

Impact of Bank of Rio Vista Acquisition on Results of Operations

On October 10, 2018, Farmers & Merchants Bancorp completed the acquisition of Bank of Rio Vista. Since the acquisition took place late in the year, and Bank of Rio Vista had only $217.5 million in assets (less than 6% of Farmers & Merchants Bancorp's total assets), the impact on the Company's 2018 Results of Operations was limited with the exception of legal fees, contract termination costs and systems conversion costs that were booked as non-interest expense by the Company in 2018. The gross amount of such expenses were $2.93 million (see Note 2, located in "Item 8. Financial Statements and Supplementary Data").

Table of Contents

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 2018, 2017 and 2016. Average balance amounts for assets and liabilities are the computed average of daily balances.

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

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, also called “changes in mix” (allocated in proportion to the respective volume and rate components).

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

Table of Contents

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

	Year Ended December 31, 2018		
Assets	Balance	Interest	Rate
Interest Bearing Deposits with Banks	$ 147,700	$ 2,755	1.87 %
Investment Securities:			
U.S. Treasuries	64,630	939	1.45 %
U.S. Govt SBA	22,537	445	1.97 %
Government Agency & Government-Sponsored Entities	3,057	88	2.88 %
Municipals - Taxable	665	5	0.75 %
Obligations of States and Political Subdivisions - Non-Taxable	53,143	2,024	3.81 %
Mortgage Backed Securities	314,937	7,682	2.44 %
Other	3,707	98	2.64 %
Total Investment Securities	462,676	11,281	2.44 %
Loans & Leases			
Real Estate	1,642,005	83,131	5.06 %
Home Equity Lines and Loans	37,086	2,041	5.50 %
Agricultural	273,178	14,067	5.15 %
Commercial	291,209	15,158	5.21 %
Consumer	9,014	503	5.58 %
Other	1,356	31	2.29 %
Leases	95,968	4,906	5.11 %
Total Loans & Leases	2,349,816	119,837	5.10 %
Total Earning Assets	2,960,192	$ 133,873	4.52 %
Unrealized Gain on Securities Available-for-Sale	(8,151)		
Allowance for Credit Losses	(52,012)		
Cash and Due From Banks	49,292		
All Other Assets	199,526		
Total Assets	$ 3,148,847		
Liabilities & Shareholders' Equity			
Interest Bearing Deposits			
Interest Bearing DDA	$ 618,674	$ 1,683	0.27 %
Savings and Money Market	844,729	1,798	0.21 %
Time Deposits	476,756	3,944	0.83 %
Total Interest Bearing Deposits	1,940,159	7,425	0.38 %
Federal Home Loan Bank Advances	36	1	2.78 %
Subordinated Debt	10,310	524	5.08 %
Total Interest Bearing Liabilities	1,950,505	$ 7,950	0.41 %
Interest Rate Spread			4.11 %
Demand Deposits	845,165		
All Other Liabilities	45,516		
Total Liabilities	2,841,186		
Shareholders' Equity	307,661		
Total Liabilities & Shareholders' Equity	$ 3,148,847		

Impact of Non-Interest Bearing Deposits and Other Liabilities		0.14 %
Net Interest Income and Margin on Total Earning Assets	125,923	4.25 %
Tax Equivalent Adjustment	(420)	
Net Interest Income	$ 125,503	4.24 %

Notes: Yields on municipal securities have been calculated on a fully taxable equivalent basis. Loan interest income includes fee income and unearned discount in the amount of $5.5 million for the year ended December 31, 2018. Non-accrual loans and lease financing receivables have been included in the average balances. Yields on securities available-for-sale are based on historical cost.

Table of Contents

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

	Year Ended December 31, 2017		
Assets	Balance	Interest	Rate
Interest Bearing Deposits with Banks	$ 176,283	$ 2,060	1.17 %
Investment Securities:			
U.S. Treasuries	81,833	891	1.09 %
U.S. Govt SBA	33,255	522	1.57 %
Government Agency & Government-Sponsored Entities	3,104	88	2.84 %
Obligations of States and Political Subdivisions - Non-Taxable	56,484	2,676	4.74 %
Mortgage Backed Securities	287,114	6,595	2.30 %
Other	1,170	27	2.31 %
Total Investment Securities	462,960	10,799	2.33 %
Loans & Leases			
Real Estate	1,556,122	73,710	4.74 %
Home Equity Lines and Loans	32,606	1,658	5.08 %
Agricultural	263,711	12,059	4.57 %
Commercial	238,650	11,117	4.66 %
Consumer	5,557	289	5.20 %
Other	1,653	37	2.24 %
Leases	80,389	3,812	4.74 %
Total Loans & Leases	2,178,688	102,682	4.71 %
Total Earning Assets	2,817,931	$ 115,541	4.10 %
Unrealized Gain on Securities Available-for-Sale	674		
Allowance for Credit Losses	(49,439)		
Cash and Due From Banks	45,063		
All Other Assets	192,978		
Total Assets	$ 3,007,207		
Liabilities & Shareholders' Equity			
Interest Bearing Deposits			
Interest Bearing DDA	$ 533,480	$ 1,053	0.20 %
Savings and Money Market	812,127	1,303	0.16 %
Time Deposits	565,412	3,509	0.62 %
Total Interest Bearing Deposits	1,911,019	5,865	0.31 %
Federal Home Loan Bank Advances	1	-	0.00 %
Subordinated Debt	10,310	424	4.11 %
Total Interest Bearing Liabilities	1,921,330	$ 6,289	0.33 %
Interest Rate Spread			3.77 %
Demand Deposits	740,088		
All Other Liabilities	51,979		
Total Liabilities	2,713,397		
Shareholders' Equity	293,810		
Total Liabilities & Shareholders' Equity	$ 3,007,207		
Impact of Non-Interest Bearing Deposits and Other Liabilities			0.10 %

Net Interest Income and Margin on Total Earning Assets	109,252	3.88 %
Tax Equivalent Adjustment	(929)	
Net Interest Income	$ 108,323	3.84 %

Notes: Yields on municipal securities have been calculated on a fully taxable equivalent basis. Loan interest income includes fee income and unearned discount in the amount of $4.9 million for the year ended December 31, 2017. Non-accrual loans and lease financing receivables have been included in the average balances. Yields on securities available-for-sale are based on historical cost.

Table of Contents

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

	Year Ended December 31, 2016		
Assets	Balance	Interest	Rate
Interest Bearing Deposits with Banks	$ 53,659	$ 287	0.53 %
Investment Securities:			
U.S. Treasuries	60,191	572	0.95 %
U.S. Govt SBA	2,323	55	2.37 %
Government Agency & Government-Sponsored Entities	25,624	197	0.77 %
Obligations of States and Political Subdivisions - Non-Taxable	60,332	2,920	4.84 %
Mortgage Backed Securities	215,528	4,663	2.16 %
Other	781	18	2.30 %
Total Investment Securities	364,779	8,425	2.31 %
Loans & Leases			
Real Estate	1,460,300	66,969	4.59 %
Home Equity Lines and Loans	31,939	1,562	4.89 %
Agricultural	266,053	10,908	4.10 %
Commercial	216,593	8,886	4.10 %
Consumer	4,987	307	6.16 %
Other	1,943	44	2.26 %
Leases	68,353	2,894	4.23 %
Total Loans & Leases	2,050,168	91,570	4.47 %
Total Earning Assets	2,468,606	$ 100,282	4.06 %
Unrealized Gain on Securities Available-for-Sale	4,895		
Allowance for Credit Losses	(43,684)		
Cash and Due From Banks	44,385		
All Other Assets	173,313		
Total Assets	$ 2,647,515		
Liabilities & Shareholders’ Equity			
Interest Bearing Deposits			
Interest Bearing DDA	$ 423,305	$ 526	0.12 %
Savings and Money Market	725,127	1,087	0.15 %
Time Deposits	513,105	2,194	0.43 %
Total Interest Bearing Deposits	1,661,537	3,807	0.23 %
Federal Home Loan Bank Advances	3,924	18	0.46 %
Subordinated Debt	10,310	371	3.60 %
Total Interest Bearing Liabilities	1,675,771	$ 4,196	0.25 %
Interest Rate Spread			3.81 %
Demand Deposits	651,709		
All Other Liabilities	53,950		
Total Liabilities	2,381,430		
Shareholders’ Equity	266,085		
Total Liabilities & Shareholders’ Equity	$ 2,647,515		
Impact of Non-Interest Bearing Deposits and Other Liabilities			0.08 %

Net Interest Income and Margin on Total Earning Assets	96,086	3.89 %
Tax Equivalent Adjustment	(1,016)	
Net Interest Income	$ 95,070	3.85 %

Notes: Yields on municipal securities have been calculated on a fully taxable equivalent basis. Loan interest income includes fee income and unearned discount in the amount of $5.1 million for the year ended December 31, 2016. Non-accrual loans and lease financing receivables have been included in the average balances. Yields on securities available-for-sale are based on historical cost.

Table of Contents

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

	2018 versus 2017 Amount of Increase (Decrease) Due to Change in:		
Interest Earning Assets	Volume	Rate	Net Chg.
Interest Bearing Deposits with Banks	$ (377)	$ 1,072	$ 695
Investment Securities:			
U.S. Treasuries	(211)	260	49
U.S. Govt SBA	(192)	115	(77)
Government Agency & Government-Sponsored Entities	(1)	1	-
Municipals - Taxable	5	-	5
Obligations of States and Political Subdivisions - Non-Taxable	(151)	(501)	(652)
Mortgage Backed Securities	663	423	1,086
Other	66	5	71
Total Investment Securities	179	303	482
Loans & Leases:			
Real Estate	4,193	5,228	9,421
Home Equity Lines and Loans	240	143	383
Agricultural	445	1,563	2,008
Commercial	2,636	1,405	4,041
Consumer	192	22	214
Other	(7)	1	(6)
Leases	780	314	1,094
Total Loans & Leases	8,479	8,676	17,155
Total Earning Assets	8,281	10,051	18,332
Interest Bearing Liabilities			
Interest Bearing Deposits:			
Interest Bearing DDA	187	443	630
Savings and Money Market	54	442	496
Time Deposits	(609)	1,044	435
Total Interest Bearing Deposits	(368)	1,929	1,561
Subordinated Debt	-	100	100
Total Interest Bearing Liabilities	(368)	2,029	1,661
Total Change	$ 8,649	$ 8,022	$ 16,671

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

Table of Contents

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

	2017 versus 2016 Amount of Increase (Decrease) Due to Change in:		
Interest Earning Assets	Volume	Rate	Net Chg.
Interest Bearing Deposits with Banks	$ 1,168	$ 605	$ 1,773
Investment Securities:			
U.S. Treasuries	227	92	319
U.S. Govt SBA	492	(25)	467
Government Agency & Government-Sponsored Entities	(287)	178	(109)
Obligations of States and Political Subdivisions -			
Non-Taxable	(237)	(7)	(244)
Mortgage Backed Securities	1,629	303	1,932
Other	8	1	9
Total Investment Securities	1,832	542	2,374
Loans & Leases:			
Real Estate	4,491	2,250	6,741
Home Equity	33	63	96
Agricultural	(97)	1,248	1,151
Commercial	957	1,274	2,231
Consumer	33	(51)	(18)
Other	(6)	(1)	(7)
Leases	546	372	918
Total Loans	5,957	5,155	11,112
Total Earning Assets	8,957	6,302	$ 15,259
Interest Bearing Liabilities			
Interest Bearing Deposits:			
Transaction	161	366	527
Savings	137	79	216
Time Deposits	243	1,072	1,315
Total Interest Bearing Deposits	541	1,517	2,058
Other Borrowed Funds	(9)	(9)	(18)
Subordinated Debt	-	53	53
Total Interest Bearing Liabilities	532	1,561	2,093
Total Change	$ 8,425	$ 4,741	$ 13,166

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

Table of Contents

2018 Compared to 2017

Net interest income increased 15.9% to $125.5 million during 2018. On a fully tax equivalent basis, net interest income increased 15.3% and totaled $125.9 million during 2018 compared to $109.3 million for 2017. As more fully discussed below, the increase in net interest income was due primarily to a $142.3 million increase in average earning assets, and a 37 basis point increase in the net interest margin.

Net interest income on a tax equivalent basis, expressed as a percentage of average total earning assets, is referred to as the net interest margin. For 2018, the Company's net interest margin was 4.25% compared to 3.88% in 2017. This increase in net interest margin was due primarily to rising market interest rates that resulted in an increase in the yield on earning assets that exceeded the increase in the cost of interest-bearing liabilities.

Average loans & leases totaled $2.3 billion for the year ended December 31, 2018; an increase of $171.1 million compared to the year ended December 31, 2017. Loans & leases increased from 77.3% of average earning assets during 2017 to 79.4% in 2018. The year-to-date yield on the loan & lease portfolio increased to 5.10% for the year ended December 31, 2018, compared to 4.71% for the year ended December 31, 2017. This higher yield combined with the impact of increased average loan & lease balances resulted in interest revenue from loans & leases increasing 16.7% to $119.8 million for 2018. The Company continues to experience aggressive competitor pricing for loans & leases to which it may need to respond in order to retain key customers. This could place negative pressure on future loan & lease yields and net interest margin.

The investment portfolio is the other main component of the Company's earning assets. Historically, the Company invested primarily in: (1) mortgage-backed securities issued by government-sponsored entities; (2) debt securities issued by the U.S. Treasury, government agencies and government-sponsored entities; and (3) investment grade bank-qualified municipal bonds. However, at certain times the Company selectively added 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. Since the risk factor for these types of investments is generally lower than that of loans & leases, the yield earned on investments is generally less than that of loans & leases.

Average investment securities decreased $284,000 in 2018 compared to the average balance during 2017. The average yield, on a tax equivalent basis, in the investment portfolio was 2.44% in 2018 compared to 2.33% in 2017. This overall increase in yield was caused primarily by an increase in the mix of mortgage-backed securities as a percentage of total securities and a decrease in the balance of lower yielding Government Agency & Government-Sponsored Entities investments. As a result of the combined impact of these balance and yield changes, tax equivalent interest income on securities increased slightly by $482,000 to $11.3 million for the year ended December 31, 2018, compared to $10.8 million for the year ended December 31, 2017. See "Financial Condition – Investment Securities" for a discussion of the Company's investment strategy in 2018. 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 primarily of FRB deposits. Balances with the FRB earn interest at the Fed Funds rate, which increased to 2.40% in December 2018. Average interest-bearing deposits with banks for the year ended December 31, 2018, was $147.7 million, a decrease of $28.6 million compared to the average balance for the year ended December 31, 2017. Interest income on interest-bearing deposits with banks for the year ended December 31, 2018, increased $695,000 to $2.8 million from the year ended December 31, 2017.

Average interest-bearing liabilities increased $29.2 million or 1.5% during the twelve months ended December 31, 2018, primarily in lower cost interest-bearing DDA, and savings and money market deposits. See “Financial Condition – Deposits” for a discussion of trends in the Company’s deposit base. Total interest expense on deposits was $7.4 million for 2018 and $5.9 million for 2017. The average rate paid on interest-bearing deposits was 0.38% in 2018 and 0.31% in 2017. See “Overview – Looking Forward: 2019 and Beyond” for a discussion of factors influencing the Company’s future deposit rates and their impact on net interest margin.

Table of Contents

2017 Compared to 2016

Net interest income increased 13.9% to $108.3 million during 2017. On a fully tax equivalent basis, net interest income increased 13.7% and totaled $109.3 million during 2017 compared to $96.1 million for 2016. As more fully discussed below, the increase in net interest income was primarily due to a $349.3 million increase in average earning assets.

Net interest income on a tax equivalent basis, expressed as a percentage of average total earning assets, is referred to as the net interest margin. For 2017, the Company's net interest margin was 3.88% compared to 3.89% in 2016. This decrease in net interest margin was due primarily to a decrease in the mix of loans and leases as a percentage of total earning assets.

Average loans & leases totaled $2.2 billion for the year ended December 31, 2017; an increase of $128.5 million compared to the year ended December 31, 2016. Loans & leases decreased from 83.1% of average earning assets during 2016 to 77.3% in 2017. The year-to-date yield on the loan & lease portfolio increased to 4.71% for the year ended December 31, 2017, compared to 4.47% for the year ended December 31, 2016. This higher yield combined with the impact of increased average loan & lease balances resulted in interest revenue from loans & leases increasing 12.1% to $102.7 million for 2017.

Average investment securities increased $98.2 million in 2017 compared to the average balance during 2016. As a result, tax equivalent interest income on securities increased $2.4 million to $10.8 million for the year ended December 31, 2017, compared to $8.4 million for the year ended December 31, 2016. The average yield, on a tax equivalent basis, in the investment portfolio was 2.33% in 2017 compared to 2.31% in 2016. This overall increase in yield was caused primarily by an increase in the mix of mortgage-backed securities as a percentage of total securities and a decrease in the balance of lower yielding Government Agency & Government-Sponsored Entities investments.

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 primarily of FRB deposits. Balances with the FRB earn interest at the Fed Funds rate, which increased to 1.50% in December 2017. Average interest-bearing deposits with banks for the year ended December 31, 2017, was $176.3 million, an increase of $122.6 million compared to the average balance for the year ended December 31, 2016. Interest income on interest-bearing deposits with banks for the year ended December 31, 2017, increased $1.8 million to $2.1 million from the year ended December 31, 2016.

Average interest-bearing liabilities increased $245.6 million or 14.7% during the twelve months ended December 31, 2017, primarily in lower cost interest-bearing DDA, and savings and money market deposits. See "Financial Condition – Deposits" for a discussion of trends in the Company's deposit base. Total interest expense on deposits was $5.9 million for 2017 and $3.8 million for 2016. The average rate paid on interest-bearing deposits was 0.31% in 2017 and 0.23% in 2016.

Provision and Allowance for Credit Losses

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

Table of Contents

Allowance for Credit Losses

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

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

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

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

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

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

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

Table of Contents

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

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

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

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

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

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

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

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

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

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

Table of Contents

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

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

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

See Note 20, located in "Item 8. Financial Statements and Supplementary Data" for a discussion of CECL and the accounting change which will impact our allowance for credit losses in 2020.

Provision for Credit Losses

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

The Central Valley of California was one of the hardest hit areas in the country during the recession. In many areas, housing prices declined as much as 60% and unemployment reached 15% or more. Although the economy has improved throughout most of the Central Valley, in many of the Company's market segments housing prices remain below peak levels and unemployment rates remain above those in other areas of the state and country. While, in management's opinion, the Company's levels of net charge-offs and non-performing assets as of December 31, 2018, compare very favorably to our peers at the present time, carefully managing credit risk remains a key focus of the Company.

The State of California experienced drought conditions from 2013 through most of 2016. Since 2016, reasonable levels of rain and snow have alleviated drought conditions in many areas of California, including those in the Company's primary service area. As a result, reservoir levels are high and the availability of water in our primary service area should not be an issue. However, the weather patterns over the past 5 years further reinforce the fact that the long-term risks associated with the availability of water are significant. See "Item 1A. Risk Factors" for additional information.

The provision for credit losses totaled $5.5 million in 2018 compared to $2.9 million in 2017. Net charge offs during 2018 were $609,000 compared to net charge offs of $427,000 during 2017 and net recoveries of $61,000 in 2016. See "Critical Accounting Policies and Estimates – Allowance for Credit Losses" and "Item 7A. Quantitative and Qualitative Disclosures About Market Risk-Credit Risk."

Table of Contents

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

	2018	2017	2016	2015	2014
Allowance for Credit Losses Beginning of Year	$50,342	$47,919	$41,523	$35,401	$34,274
Provision Charged to Expense	5,533	2,850	6,335	750	1,175
Charge-Offs:					
Commercial Real Estate	-	109	-	-	-
Agricultural Real Estate	-	-	-	-	-
Real Estate Construction	-	-	-	-	-
Residential 1st Mortgages	31	53	21	-	73
Home Equity Lines and Loans	8	3	46	-	70
Agricultural	-	374	-	-	-
Commercial	613	-	-	12	1
Consumer & Other	115	146	105	84	132
Total Charge-Offs	767	685	172	96	276
Recoveries:					
Commercial Real Estate	2	109	2	2,939	11
Agricultural Real Estate	-	-	-	-	-
Real Estate Construction	-	-	-	2,225	-
Residential 1st Mortgages	15	40	26	8	-
Home Equity Lines and Loans	6	8	103	87	58
Agricultural	61	17	-	4	8
Commercial	20	8	47	136	86
Consumer & Other	54	76	55	69	65
Total Recoveries	158	258	233	5,468	228
Net (Charge-Offs) Recoveries	(609)	(427)	61	5,372	(48)
Total Allowance for Credit Losses, End of Year	$55,266	$50,342	$47,919	$41,523	$35,401
Ratios:					
Allowance for Credit Losses to:					
Total Loans & Leases at Year End	2.14%	2.27%	2.19%	2.07%	2.06%
Average Loans & Leases	2.35%	2.31%	2.34%	2.30%	2.36%
Consolidated Net (Charge-Offs) Recoveries to:					
Total Loans & Leases at Year End	(0.02%)	(0.02%)	0.00%	0.27%	(0.00%)
Average Loans & Leases	(0.03%)	(0.02%)	0.00%	0.30%	(0.00%)

Table of Contents

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

December 31, 2018	Commercial Real Estate	Agricultural Real Estate	Real Estate Constrction	Residential 1st Mortgages	Home Equity Lines & Loans	Agricultural	Commercial	Consumer & Other	Leases	Unallocated	Total
Year-To-Date Allowance for Credit Losses:											
Beginning Balance- January 1, 2018	$10,922	$12,085	$1,846	$815	$2,324	$8,159	$9,197	$209	$3,363	$1,422	$50,342
Charge-Offs	-	-	-	(31)	(8)	-	(613)	(115)	-	-	(767)
Recoveries	2	-	-	15	6	61	20	54	-	-	158
Provision	685	2,007	(597)	81	439	22	3,052	346	659	(1,161)	5,533
Ending Balance- December 31, 2018	$11,609	$14,092	$1,249	$880	$2,761	$8,242	$11,656	$494	$4,022	$261	$55,266

Overall, the Allowance for Credit Losses as of December 31, 2018 increased $4.9 million from December 31, 2017. The allowance allocated to the following categories of loans changed as indicated during the twelve months ended December 31, 2018:

- Agricultural Real Estate allowance balances increased $2.0 million due primarily to an increase in substandard loans related to two borrowers.

- Commercial allowance balances increased $2.5 million due to an increase in loan balances along with an increase in the 3-year average historical loss rate used in the allowance calculation.

	Allowance Allocation at December 31,									
(in thousands)	2018 Amount	Percent of Loans in Each Category to Total Loans	2017 Amount	Percent of Loans in Each Category to Total Loans	2016 Amount	Percent of Loans in Each Category to Total Loans	2015 Amount	Percent of Loans in Each Category to Total Loans	2014 Amount	Percent of Loans in Each Category to Total Loans
Commercial Real Estate	$11,609	32.4 %	$10,922	31.1 %	$11,110	30.9 %	$10,063	30.4 %	$7,842	28.9 %
Agricultural Real Estate	14,092	22.7 %	12,085	22.5 %	9,450	21.4 %	6,881	21.2 %	4,185	20.8 %
Real Estate Construction	1,249	3.8 %	1,846	4.5 %	3,223	8.1 %	2,485	7.6 %	1,669	5.6 %

Residential 1st Mortgages	880	10.1 %	815	11.7 %	865	11.1 %	789	10.3 %	1,022	10.0 %
Home Equity Lines and Loans	2,761	1.6 %	2,324	1.6 %	2,140	1.4 %	2,146	1.7 %	2,426	1.9 %
Agricultural	8,242	11.3 %	8,159	12.3 %	7,381	13.5 %	6,308	14.7 %	6,104	16.4 %
Commercial	11,656	13.3 %	9,197	12.0 %	8,515	10.0 %	7,836	10.5 %	8,195	13.5 %
Consumer & Other	494	0.8 %	209	0.3 %	200	0.3 %	175	0.3 %	218	0.3 %
Leases	4,022	4.0 %	3,363	4.0 %	3,586	3.3 %	3,294	3.3 %	2,211	2.6 %
Unallocated	261		1,422		1,449		1,546		1,529	
Total	$55,266	100.0 %	$50,342	100.0 %	$47,919	100.0 %	$41,523	100.0 %	$35,401	100.0 %

As of December 31, 2018, the allowance for credit losses was $55.3 million, which represented 2.14% of the total loan & lease balance. At December 31, 2017, the allowance for credit losses was $50.3 million or 2.27% of the total loan & lease balance. After reviewing all factors above, based upon information currently available, management concluded that the allowance for credit losses as of December 31, 2018, is 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: 2019 and Beyond.”

Table of Contents

2018 Compared to 2017

Non interest income totaled $15.2 million for 2018, a decrease of $1.5 million or 9.2% from non-interest income of $16.8 million for 2017.

Net (loss) gain on investment securities was a net loss of $1.3 million in 2018 compared to a net gain of $131,000 for 2017. See “Financial Condition-Investment Securities” for a discussion of the Company’s investment strategy.

Debit card and ATM fees totaled $4.4 million in 2018, an increase of 12.7% or $492,000 from $3.9 million in 2017. This was primarily due to increased numbers of cardholders and increased account activity.

Net gains on deferred compensation plan investments were $1.1 million in 2018 compared to net gains of $2.6 million in 2017. See Note 16, located in “Item 8. Financial Statements and Supplementary Data” for a description of these plans. Balances in non-qualified deferred compensation plans may be invested in financial instruments whose market value fluctuates based upon trends in interest rates and stock prices. Although Generally Accepted Accounting Principles require these investment gains/losses be recorded in non-interest income, an offsetting entry is also required to be made to non-interest expense resulting in no effect on the Company’s net income.

Other non-interest income was $5.6 million, an increase of $727,000 or 14.9% from 2017. This increase was primarily due to: (1) $997,000 of income as a result of the remeasurement of the initial investment in Bank of Rio Vista stock; (2) FHLB dividend increases of $208,000; (3) Check Order Income increases of $116,000; and (4) increases in gain on sale of Leases of $76,000; offset by a drop in the gain on sale of fixed assets by $900,000.

2017 Compared to 2016

Non interest income totaled $16.8 million for 2017, an increase of $1.5 million or 9.9% from non-interest income of $15.3 million for 2016.

Service charges on deposit accounts totaled $3.5 million for 2017, an increase of $77,000 or 2.1% from service charges on deposit accounts of $3.4 million in 2016. This was due primarily to fees related to the Company’s Overdraft Privilege Service.

Net gain (loss) on investment securities was a net gain of $131,000 in 2017 compared to a net loss of $284,000 for 2016.

Debit card and ATM fees totaled $3.9 million in 2017, an increase of 14.0% or $475,000 from $3.4 million in 2016. This was primarily due to increased numbers of cardholders and increased account activity.

Net gains on deferred compensation plan investments were $2.6 million in 2017 compared to net gains of $2.0 million in 2016. 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.

There was no bargain purchase gain in 2017 as this gain related to the purchase of Delta National Bancorp, which took place in 2016.

Other non-interest income was $4.9 million, an increase of $1.8 million or 60.2% from 2016. This increase was primarily comprised of: (1) a $1.1 million increase in the gain on sale of fixed assets related to the disposition of one of the Company’s properties; (2) $453,000 in non-recurring fees from certain loan customers; and (3) $402,000 in dividend income on equity securities.

49

Table of Contents

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.

2018 Compared to 2017

Overall, non-interest expense totaled $75.5 million for 2018, an increase of $7.4 million or 11.4% from the year ended December 31, 2017.

Salaries and employee benefits increased $4.3 million or 9.4% in 2018, primarily related to: (1) new staff from the acquisition of the Bank of Rio Vista; (2) general salary increases; and (3) increased contributions to retirement and profit sharing plans.

Net gains on deferred compensation plan investments were $1.1 million in 2018 compared to net gains of $2.6 million in 2017. 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.

Occupancy expense in 2018 totaled $3.9 million, an increase of $362,000 or 10.2% from 2017 and equipment expense in 2018 totaled $4.3 million, an increase of $309,000 or 7.7% from 2017. Both of these increases were primarily related to operating expenses associated with remodeling existing branch offices.

Legal expenses increased $544,000 from 2017 and totaled $968,000. This increase was primarily due to legal fees associated with the repurchase of stock and other operating matters.

Acquisition expenses related to the Bank of Rio Vista totaled $2.93 million. A majority of this expense was comprised of: (1) legal and other professional fees; (2) contract termination costs; and (3) conversion expenses related to the core processing systems for both Bank of Rio Vista and F&M Bank.

2017 Compared to 2016

Overall, non-interest expense totaled $67.8 million for 2017, an increase of $9.6 million or 16.5% from the year ended December 31, 2016.

Salaries and employee benefits increased $3.8 million or 9.0% in 2017, primarily related to: (1) new staff from the acquisition of Delta National Bancorp; (2) bank wide raises that occurred in mid-2017; and (3) increased contributions to retirement and profit sharing plans.

Net gains on deferred compensation plan investments were $2.6 million in 2017 compared to net gains of $2.0 million in 2016. 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 2017 totaled $3.5 million, an increase of $558,000 or 18.7% from 2016 and equipment expense in 2017 totaled $4.0 million, an increase of $501,000 or 14.3% from 2016. Both of these increases were primarily related to operating expenses associated with: (1) 3 new branches from the acquisition of Delta National Bancorp and (2) remodeling existing branch offices.

Legal expenses decreased $819,000 from 2016 and totaled $424,000. This decrease was primarily due to legal fees related to: (1) changes to the Company’s by-laws and extension of the Company’s shareholder rights agreement; (2) trademark/branding issues; and (3) the Delta National Bancorp acquisition, which were paid in 2016.

Table of Contents

Gain on sale of ORE property totaled $414,000 in 2017 compared to $5.9 million for 2016. During 2016, the Company sold at a substantial gain a large parcel of ORE that was acquired through foreclosure in 2008.

Other non-interest expense decreased $108,000, or 1.1%, to $9.9 million in 2017 compared to $10.0 million in 2016.

Income Taxes

On December 22, 2017, the Tax Cuts and Jobs Act was signed into law changing the Company's Federal corporate tax rate from 35% to 21%. The Company's provision for income taxes decreased 45.61% to $14.0 million during 2018 compared to 2017 primarily as a result of: (1) the Federal corporate tax rate change and (2) the Company having amended and planning to amend tax returns in open tax years resulting in a reduction of $990,000 in the Company's tax provision for 2018. See "Note 1. Significant Accounting Policies – Out of Period Adjustment." The effective tax rate for 2018 was 23.8% compared to 47.9% during 2017.

Also due to the signing of the Tax Cuts and Jobs Act, during the 4th quarter of 2017, all companies were required to re-measure their deferred tax assets (DTA) and deferred tax liabilities (DTL) at the new corporate tax rate of 21%. This one-time re-measurement resulted in a $6.3 million increase to the Company's income tax provision in 2017. This DTA re-measurement accompanied by an 8.7% increase in pre-tax earnings resulted in the tax provision increase in 2017.

With the exception of the one-time DTA re-measurement that took place in 2017, tax law causes the Company's taxes payable to approximate or exceed the current provision for taxes on the income statement. Three provisions have had a significant effect on the Company's current income tax liability: (1) the restrictions on the deductibility of credit losses; (2) deductibility of pension and other long-term employee benefits only when paid; and (3) the statutory deferral of deductibility of California franchise taxes on the Company's federal return.

Financial Condition

Investment Securities and Federal Funds Sold

The investment portfolio provides the Company with an income alternative to loans & leases. The debt securities in the Company's investment portfolio have historically been comprised primarily of: (1) mortgage-backed securities issued by federal government-sponsored entities; (2) debt securities issued by US Treasury, government agencies and government-sponsored entities; and (3) investment grade bank-qualified municipal bonds. However, at certain times, the Company has selectively added 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.

The Company's investment portfolio at December 31, 2018 was $549.0 million compared to $536.1 million at December 31, 2017, an increase of $12.9 million or 2.4%. To protect against future increases in market interest rates, while at the same time generating some reasonable level of current yields, the Company currently invests most of its available funds in either shorter term U.S. Treasury, government agency & government-sponsored entity securities or shorter term (10, 15, and 20 year) mortgage-backed securities.

The Company's total investment portfolio currently represents 16.0% of the Company's total assets as compared to 17.4% at December 31, 2017.

As of December 31, 2018, the Company held $53.6 million of municipal investments, of which $34.9 million were bank-qualified municipal bonds, all classified as held-to-maturity ("HTM"). In order to comply with Section 939A of the Dodd-Frank Act, the Company performs its own credit analysis on new purchases of municipal bonds. As of December 31, 2018, ninety-nine percent of the Company's bank-qualified municipal bond portfolio is rated at either the issue or issuer level, and all of these ratings are "investment grade." The Company monitors the status of all municipal investments with particular attention paid to the approximately one percent ($150,000) 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.

Table of Contents

Not included in the investment portfolio are interest bearing deposits with banks and overnight investments in Federal Funds Sold. Interest bearing deposits with banks consisted primarily of FRB deposits. The FRB currently pays interest on the deposits that banks maintain in their FRB accounts, whereas historically banks had to sell these Federal Funds to other banks in order to earn interest. Since balances at the FRB are effectively risk free, the Company elected to maintain its excess cash at the FRB. Interest bearing deposits with banks totaled $84.5 million at December 31, 2018 and $121.2 million at December 31, 2017.

The Company classifies its investments as held-to-maturity, trading, or available-for-sale (“AFS”). Securities are classified as held-to-maturity and are carried at amortized cost when the Company has the intent and ability to hold the securities to maturity. Trading securities are securities acquired for short-term appreciation and are carried at fair value, with unrealized gains and losses recorded in non-interest income. As of December 31, 2018 and December 31, 2017, there were no securities in the trading portfolio. Securities classified as available-for-sale include securities, which may be sold to effectively manage interest rate risk exposure, prepayment risk, satisfy liquidity demands and other factors. These securities are reported at fair value with aggregate, unrealized gains or losses excluded from income and included as a separate component of shareholders’ equity, net of related income taxes.

Table of Contents

Investment Portfolio

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

December 31: (in thousands)	Available for Sale 2018	Held to Maturity	Available for Sale 2017	Held to Maturity	Available for Sale 2016	Held to Maturity
U.S. Treasury Notes	$164,514	$-	$144,164	$-	$134,428	$-
U.S. Government SBA	15,447	-	29,380	-	36,314	-
Government Agency & Government Sponsored Entities	3,039	-	3,128	-	3,241	-
Obligations of States and Political Subdivisions - Non-Taxable	-	53,566	-	54,460	-	58,109
Mortgage Backed Securities	307,045	-	301,914	-	273,270	-
Other	5,351	-	3,010	-	1,010	-
Total Book Value	$495,396	$53,566	$481,596	$54,460	$448,263	$58,109
Fair Value	$495,396	$53,738	$481,596	$58,408	$448,263	$62,388

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, 2018.

December 31, 2018 (in thousands)	Fair Value	Average Yield	
U.S. Treasury			
One year or less	$149,934	2.08	%
After one year through five years	14,580	2.32	%
Total U.S. Treasury Securities	164,514	2.10	%
U.S. Government SBA			
After one year through five years	879	3.17	%
After five years through ten years	1,472	3.53	%
After ten years	13,096	3.17	%
Total U.S. Government Securities	15,447	3.21	%
Government Agency & Government Sponsored Entities			
After one year through five years	3,039	2.91	%
Total Government Agency & Government Sponsored Entities	3,039	2.91	%
Other			
One year or less	5,351	2.22	%
Total Other Securities	5,351	2.22	%
Mortgage Backed Securities	307,045	2.68	%
Total Investment Securities Available-for-Sale	$495,396	2.50	%

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, 2018. Non-taxable Obligations of States and Political Subdivisions have been calculated on a fully taxable equivalent basis.

December 31, 2018 (in thousands)	Book Value	Average Yield

Obligations of States and Political Subdivisions - Non-Taxable			
One year or less	$2,340	4.32	%
After one year through five years	2,161	2.07	%
After five years through ten years	21,167	3.58	%
After ten years	27,898	4.50	%
Total Obligations of States and Political Subdivisions - Non-Taxable	53,566	4.03	%
Total Investment Securities Held-to-Maturity	$53,566	4.03	%

Table of Contents

Loans & Leases

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

Commercial and Agricultural Real Estate - These are loans secured by farmland, commercial real estate, multifamily residential properties, and other non-farm, non-residential properties generally 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 or LIBOR with an appropriate spread based on the amount of perceived risk in the loan.

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

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

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

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

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

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

Table of Contents

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

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

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

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

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

Overall, the Company's loan & lease portfolio at December 31, 2018 totaled $2.6 billion, an increase of $355.9 million or 16.1% over December 31, 2017. This increase occurred as a result of: (1) the Company's business development efforts directed toward credit-qualified borrowers; (2) expansion in the equipment leasing business; (3) expansion of our service area into the East Bay of San Francisco and Napa; and (4) the acquisition of the Bank of Rio Vista which added $80.5 million to loan balances. No assurances can be made that this growth in the loan & lease portfolio will continue.

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

	2018		2017		2016		2015		2014	
(in thousands)	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percen
Commercial Real Estate	$834,476	32.4 %	$691,639	31.1 %	$674,445	30.9 %	$609,602	30.4 %	$495,316	28.9
Agricultural Real Estate	584,625	22.7 %	499,231	22.5 %	467,685	21.4 %	424,034	21.2 %	357,207	20.8
Real Estate Construction	98,568	3.8 %	100,206	4.5 %	176,462	8.1 %	151,974	7.6 %	96,519	5.6
Residential 1st Mortgages	259,736	10.1 %	260,751	11.7 %	242,247	11.1 %	206,405	10.3 %	171,880	10.0
Home Equity Lines and Loans	40,789	1.6 %	34,525	1.6 %	31,625	1.4 %	33,056	1.7 %	33,017	1.9

Agricultural	290,463	11.3 %	273,582	12.3 %	295,325	13.5 %	293,966	14.7 %	281,963	16.4
Commercial	343,834	13.3 %	265,703	12.0 %	217,577	10.0 %	210,804	10.5 %	230,819	13.5
Consumer & Other	19,412	0.8 %	6,656	0.3 %	6,913	0.3 %	6,592	0.3 %	4,719	0.3
Leases	106,217	4.0 %	88,957	4.0 %	70,986	3.3 %	65,054	3.3 %	44,217	2.6
Total Gross Loans & Leases	2,578,120	100.0%	2,221,250	100.0%	2,183,265	100.0%	2,001,487	100.0%	1,715,657	100.(
Less: Unearned Income	6,879		5,955		5,664		5,128		3,413	
Subtotal	2,571,241		2,215,295		2,177,601		1,996,359		1,712,244	
Less: Allowance for Credit Losses	55,266		50,342		47,919		41,523		35,401	
Loans & Leases, Net	$2,515,975		$2,164,953		$2,129,682		$1,954,836		$1,676,843	

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.

55

Table of Contents

The following table shows the maturity distribution and interest rate sensitivity of the loan portfolio of the Company on December 31, 2018.

(in thousands)	One Year or Less	Over One Year to Five Years	Over Five Years	Total
Commercial Real Estate	$33,099	$228,391	$565,059	$826,549
Agricultural Real Estate	20,654	111,989	451,982	584,625
Real Estate Construction	62,978	30,915	4,675	98,568
Residential 1st Mortgages	85	8,799	250,852	259,736
Home Equity Lines and Loans	5	601	40,183	40,789
Agricultural	176,913	94,435	19,115	290,463
Commercial	110,641	170,447	62,746	343,834
Consumer & Other	665	7,160	11,587	19,412
Leases	218	43,054	63,993	107,265
Total	$405,258	$695,791	$1,470,192	$2,571,241
Rate Sensitivity:				
Fixed Rate	$53,123	$354,924	$779,440	$1,187,487
Variable Rate	352,134	340,868	690,752	1,383,754
Total	$405,257	$695,792	$1,470,192	$2,571,241
Percent	15.76 %	27.06 %	57.18 %	100.00 %

Classified Loans & Leases and Non-Performing Assets

All loans & leases are assigned a credit risk grade using grading standards developed by bank regulatory agencies. See "Results of Operations - Provision and Allowance for Credit Losses" for more detail on risk grades. The Company utilizes the services of a third-party independent loan & lease review firm to perform evaluations of individual loans & leases and review the credit risk grades the Company places on loans & leases. Loans & leases that are judged to exhibit a higher risk profile are referred to as "classified" and these loans & leases receive increased management attention. As of December 31, 2018, classified loans & leases totaled $14.7 million compared to $8.9 million at December 31, 2017.

Classified loans & leases with higher levels of credit risk can be further designated as "impaired" loans & leases. A loan or lease is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts due, including principal and interest, according to the contractual terms of the original agreement. See "Results of Operations - Provision and Allowance for Credit Losses" for further details. Impaired loans & leases consist of: (1) non-accrual loans & leases; and/or (2) restructured loans & leases that are still performing (i.e., accruing interest).

Non-Accrual Loans & Leases - Accrual of interest on loans & leases is generally discontinued when a loan or lease becomes contractually past due by 90 days or more with respect to interest or principal. When loans & leases 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 or lease is placed on non-accrual status, all interest previously accrued but not collected is reversed. Income on such loans & leases is then recognized only to the extent that cash is received and where the future collection of principal is probable. There were no nonaccrual loans & leases at December 31, 2018 and 2017.

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

Table of Contents

At December 31, 2018, restructured loans totaled $13.6 million all of which were performing and at December 31, 2017, restructured loans totaled $6.3 million all of which were performing.

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 & leases and ORE as of December 31 of the years indicated.

(in thousands)	2018	2017	December 31, 2016	2015	2014
Non-Accrual Loans & Leases					
Commercial Real Estate	$-	$-	$ -	$19	$-
Agricultural Real Estate	-	-	1,304	-	-
Real Estate Construction	-	-	-	-	-
Residential 1st Mortgages	-	-	95	65	77
Home Equity Lines and Loans	-	-	-	538	576
Agricultural	-	-	243	-	18
Commercial	-	-	1,426	1,524	1,586
Consumer & Other	-	-	6	10	13
Total Non-Accrual Loans & Leases	-	-	3,074	2,156	2,270
Accruing Loans & Leases Past Due 90 Days or More					
Commercial Real Estate	-	-	-	-	-
Agricultural Real Estate	-	-	-	-	-
Real Estate Construction	-	-	-	-	-
Residential 1st Mortgages	-	-	-	-	-
Home Equity Lines and Loans	-	-	-	-	-
Agricultural	-	-	-	-	-
Commercial	-	-	-	-	-
Consumer & Other	-	-	-	-	-
Total Accruing Loans & Leases Past Due 90 Days or More	-	-	-	-	-
Total Non-Performing Loans & Leases	$-	$-	$ 3,074	$2,156	$2,270
Other Real Estate Owned	$873	$873	$ 3,745	$2,441	$3,299
Total Non-Performing Assets	$873	$873	$ 6,819	$4,597	$5,569
Restructured Loans & Leases (Performing)	$13,577	$6,301	$ 4,462	$4,953	$4,955
Non-Performing Loans & Leases as a Percent of Total Loans & Leases	0.00 %	0.00 %	0.14 %	0.11 %	0.13 %

Although management believes that non-performing loans & leases are generally well-secured and that potential losses are provided for in the Company's allowance for credit 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 6, located in "Item 8. Financial Statements and Supplementary Data" for an allocation of the allowance classified to impaired loans & leases.

The Company reported $873,000 of ORE at December 31, 2018, and at December 31, 2017. ORE at December 31, 2018 consisted of commercial land.

Except for those classified and non-performing loans & leases discussed above, the Company's management is not aware of any loans & leases as of December 31, 2018, 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 or lease repayment terms, or any known events that would result in the loan or lease being designated as non-performing at some future date. However:

Table of Contents

- The Central Valley was one of the hardest hit areas in the country during the recession. In many areas housing prices declined as much as 60% and unemployment reached 15% or more. Although the economy has strengthened throughout most of the Central Valley, for the most part housing prices remain below peak levels and unemployment levels remain above those in other areas of the state and country.

- The State of California experienced drought conditions from 2013 through most of 2016. Since 2016, reasonable levels of rain and snow have alleviated drought conditions in many areas of California, including those in the Company’s primary service area. As a result, reservoir levels are high and the availability of water in our primary service area should not be an issue. However, the weather patterns over the past 5 years further reinforce the fact that the long-term risks associated with the availability of water are significant.

- The agricultural industry is facing challenges associated with: (1) weakness in export markets due to a stronger dollar and proposed changes in trade policies; (2) tight labor markets and higher wages due to legislative changes at the state and federal levels; and (3) proposed changes in immigration policy and the resulting impact on the labor pool.

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 $250,000 or more at December 31, 2018.

(in thousands)	
Time Deposits of $250,000 or More	
Three Months or Less	$104,058
Over Three Months Through Six Months	56,927
Over Six Months Through Twelve Months	31,184
Over Twelve Months	26,853
Total Time Deposits of $250,000 or More	$219,022

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, 2018, deposits totaled $3.1 billion. This represents an increase of 12.5% or $339.6 million from December 31, 2017. In addition to the Company’s ongoing business development activities for deposits, the following factors positively impacted year-over-year deposit growth: (1) 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 area; (2) the Company’s expansion of its service area into Walnut Creek and Concord; and (3) the acquisition of the Bank of Rio Vista which added $191.6 million in deposit balances. Market interest rates have been increasing over the past 24 months, resulting in significant competitive pressures on deposit rates. The Company remains selective in how they respond to competitor rates, which may impact future deposit growth.

Although total deposits have increased 12.5% since December 31, 2017, importantly, low cost transaction accounts have grown at a strong pace:

- Demand and interest-bearing transaction accounts increased $235.0 million or 16.4% since December 31, 2017.
- Savings and money market accounts have increased $90.0 million or 11.1% since December 31, 2017.
- Time deposit accounts have increased $14.6 million or 3.1% since December 31, 2017.

Table of Contents

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 at December 31, 2018 or 2017. There were no Federal Funds purchased or advances from the FRB at December 31, 2018 or 2017.

Long-Term Subordinated Debentures

On December 17, 2003, the Company raised $10.0 million through the sale of subordinated debentures to an off-balance sheet trust and its sale 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, our TPS will continue to qualify as regulatory capital. These securities accrue interest at a variable rate based upon 3-month London InterBank Offered Rate ("LIBOR") plus 2.85%. Interest rates reset quarterly (the next reset is March 15, 2019) and the rate was 5.64% as of December 31, 2018. The average rate paid for these securities was 5.08% in 2018 and 4.11% in 2017. 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 $311.2 million at December 31, 2018, and $300.0 million at the end of 2017.

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.

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

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

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.”

Table of Contents

As previously discussed, in order to supplement its regulatory capital base, during December 2003, the Company issued $10.0 million of trust preferred securities. 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 November 6, 2018, the Board of Directors approved an extension of the $20 million stock repurchase program over the three-year period ending December 31, 2021. See “Item 5. Market for Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities” of the Company’s 2017 Annual Report on Form 10-K for additional information.

There were no stock repurchases in 2018 or 2017 under the Common Stock Repurchase Plan. However, in the third quarter of 2018 the Company did repurchase $31.2 million of shares, at $700 per share, in a single transaction from the estate of a large shareholder. The remaining dollar value of shares that may yet be purchased under the Company’s Common Stock Repurchase Plan 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 Computershare as Rights Agent. The Rights Plan was set to expire on August 5, 2018. On November 19, 2015, the Board of Directors approved a seven-year extension of the term of the Rights Plan. Pursuant to an Amendment to the Rights Agreement dated February 18, 2016, the term of the Rights Plan was extended from August 5, 2018 to August 5, 2025. The extension of the term of the Rights Plan was intended as a means to continue to guard against abusive takeover tactics and was not in response to any particular proposal. See “Item 5. Market for Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities” for further explanation.

During 2018, the Company issued a combined total 13,520 shares of common stock to the Bank’s non-qualified defined contribution retirement plans. There were also 2,400 shares issued to individuals during 2018. All of the shares were issued at prices ranging from $635.00 to $690.00 per share based upon valuations completed during the quarter of issuance by a nationally recognized bank consulting and advisory firm and in reliance upon the exemption in Section 4(a)(2) of the Securities Act of 1933, as amended, and the regulations promulgated thereunder. The proceeds were contributed to the Bank as equity capital.

During 2017, the Company issued 4,975 shares of common stock, which were contributed to the Bank’s non-qualified defined contribution retirement plans. The shares issued had prices ranging from $590 per share to $595 per share. These share prices were based upon valuations completed by a nationally recognized bank consulting and advisory firm and in reliance upon the exemption in Section 4(a)(2) of the Securities Act of 1933, as amended, and the regulations promulgated thereunder. The proceeds from these issuances were contributed to the Bank as equity capital. See Note 14, located in “Item 8. Financial Statements and Supplementary Data.”

During 2016, the Company issued 16,542 shares of common stock, of which 4,610 shares were contributed to the Bank’s non-qualified defined contribution retirement plans and 11,932 shares were issued in the acquisition of Delta National Bancorp. The shares issued had prices ranging from $525 per share to $580 per share. These share prices were based upon valuations completed by a nationally recognized bank consulting and advisory firm and in reliance upon the exemption in Section 4(a)(2) of the Securities Act of 1933, as amended, and the regulations promulgated thereunder. The proceeds from these issuances were contributed to the Bank as equity capital.

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 Credit 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 credit 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 credit losses. On a quarterly basis, management reviews the credit quality of the loan & lease portfolio and considers problem loans & leases, delinquencies, internal credit reviews, current economic conditions, loan & lease 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 6, located in “Item 8. Financial Statements and Supplementary Data.”

See Note 20, located in “Item 8. Financial Statements and Supplementary Data” for a discussion of CECL and the accounting change which will impact our allowance for credit losses in 2020.

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.”

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.”

Valuation of Goodwill - Goodwill is not amortized but instead is periodically tested for impairment. Management performs this impairment analysis on an annual basis as of December 31. Additionally, events or circumstances are analyzed on an interim basis to determine if there is an indication of a potential impairment. The impairment analysis requires management to make subjective judgments. Events and factors that may significantly affect the estimates include, among others, a significant decline in expected future cash flows, a significant adverse change in the business climate, slower growth rates or a significant and sustained decline in the price of our common stock, changes in discount rates and specific industry and market conditions. There can be no assurance that changes in circumstances, estimates or assumptions may result in additional impairment of all, or some portion of, goodwill.

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.

Table of Contents

(in thousands)	December 31, 2018	December 31, 2017
Commitments to Extend Credit	$ 828,539	$ 735,678
Letters of Credit	19,108	20,061
Performance Guarantees Under Interest Rate Swap Contracts Entered Into Between Our Borrowing Customers and Third Parties	-	759

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.

Standby letters of credit are conditional commitments issued by the Company to guarantee performance of or payment for a customer to a third party. Most standby letters of credit are issued for 12 months or less. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Additionally, the Company maintains a reserve for off balance sheet commitments, which totaled $315,000 at December 31, 2018 and $267,000 at December 31, 2017. We do not anticipate any material losses as a result of these transactions.

Aggregate Contractual Obligations and Commitments

The following table presents, as of December 31, 2018, 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."

(in thousands)	Total	1 Year or Less	2-3 Years	4-5 Years	More Than 5 Years
Operating Lease Obligations	$2,977	$ 782	$ 1,299	$ 403	$ 493
Long-Term Subordinated Debentures	10,310	-	-	-	10,310
Deferred Compensation [(1)]	54,194	1,531	1,115	1,000	50,548
Total	$67,481	$ 2,313	$ 2,414	$ 1,403	$ 61,351

[(1)] These amounts represent obligations to participants under the Company's various non-qualified deferred compensation plans. All amounts have been fully funded in to a Rabbi Trust as of December 31, 2018. See Note 16 located in "Item 8. Financial Statements and Supplementary Data."

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.

Table of Contents

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 & lease portfolio the Company has established credit management policies and procedures that govern both the approval of new loans & leases and the monitoring of the existing portfolio. The Company manages and controls credit risk through comprehensive underwriting and approval standards, dollar limits on loans & leases to one borrower, and by restricting loans & leases made primarily to its principal market area where management believes it is best able to assess the applicable risk. Additionally, management has established guidelines to ensure the diversification of the Company's credit portfolio such that even within key portfolio sectors such as real estate or agriculture, the portfolio is diversified across factors such as location, building type, crop type, etc. However, as a financial institution that assumes credit risks as a principal element of its business, credit losses will be experienced in the normal course of business. The allowance for credit losses is maintained at a level considered by management to be adequate to provide for risks inherent in the loan & lease 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 & leases. The systematic methodology consists of three parts.

Part 1 - includes a detailed analysis of the loan & lease portfolio in two phases. The first phase is conducted in accordance with the "Receivables" topic of the FASB ASC. Individual loans & leases are reviewed to identify them for impairment. A loan or lease is impaired when principal and interest are deemed uncollectible in accordance with the original contractual terms of the loan or lease. Impairment is measured as either the expected future cash flows discounted at each loan's or lease's effective interest rate, the fair value of the loan's or lease's collateral if the loan or lease is collateral dependent, or an observable market price of the loan or lease, 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 & lease portfolio is the risk rating system. The originating credit officer assigns each borrower an initial risk rating, which is based primarily on a thorough analysis of that 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 DBO 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 or lease is impaired and there is a probability of loss. Management performs a detailed analysis of these loans & leases, 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 & lease portfolio by risk rating and into groups of loans & leases with similar characteristics in accordance with the "Contingency" topic of the FASB ASC. In this second phase, groups of loans & leases 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 or leases.

Part 2 - considers qualitative internal and external factors that may affect a loan or lease'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 service areas of the Company;
§ credit quality trends (including trends in collateral values, delinquencies and non-performing loans & leases);
§ loan & lease volumes, growth rates and concentrations;
§ loan & lease portfolio seasoning;

Table of Contents

§ specific industry and crop conditions;
§ recent loss experience; and
§ duration of the current business cycle.

Part 3 - An unallocated allowance generally occurs due to the imprecision in estimating and allocating allowance balances associated with macro factors such as: (1) the improving but still challenging economic conditions in the Central Valley; and (2) the long-term risks associated with the availability of water in the Central Valley.

Management reviews all of 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 element of the allowance or in the unallocated allowance.

Management believes, that based upon the preceding methodology, and using information currently available, the allowance for credit losses at December 31, 2018 was adequate. No assurances can be given that future events may not result in increases in delinquencies, non-performing loans & leases, or net loan & lease charge-offs that would require increases in the provision for credit 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 & lease, 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 & leases. In addition, the magnitude of changes in the rates charged on loans & leases 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, 2018, 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 2.25% if rates increase by 200 basis points and a decrease in net interest income of 5.80% if rates decline 100 basis points.

Table of Contents

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 & leases and securities; pricing strategies on loans & leases 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 & leases, 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 $78 million and repurchase lines of $130 million with major banks. As of December 31, 2018, the Company has additional borrowing capacity of $565.5 million with the Federal Home Loan Bank and $453.0 million with the Federal Reserve Bank. Borrowings under these lines are collateralized with loans or securities that have been accepted for pledging at the FHLB and FRB.

At December 31, 2018, the Company had available sources of liquidity, which included cash and cash equivalents and unpledged investment securities available-for-sale of approximately $340.8 million, which represents 10% of total assets.

Item 8. Financial Statements and Supplementary Data

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS
AND FINANCIAL STATEMENT SCHEDULES

Table of Contents
Farmers & Merchants Bancorp

Report of Management on Internal Control Over Financial Reporting

Management of Farmers & Merchants Bancorp and Subsidiaries (the "Company") is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934, and for performing an assessment of the effectiveness of internal control over financial reporting as of December 31, 2018. The Company's internal control over financial reporting is a process designed under the supervision of the Company's management, including the Chief Executive Officer and Chief Financial Officer, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with accounting principles generally accepted in the United States.

The Company's system of internal control over financial reporting includes policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect transactions and dispositions of assets of the Company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with accounting principles generally accepted in the United States, and that receipts and expenditures of the Company are being made only in accordance with authorizations of management and directors of the Company; and (iii) 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.

Management recognizes that there are inherent limitations in the effectiveness of any system of internal control, and accordingly, even effective internal control can provide only reasonable assurance with respect to financial statement preparation and fair presentation. Further, because of changes in conditions, the effectiveness of internal control may vary over time.

Under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer and Chief Financial Officer, the Company performed an assessment of the effectiveness of the Company's internal control over financial reporting as of December 31, 2018 as described in "Internal Control-Integrated Framework (2013)" issued by the Committee of Sponsoring Organizations of the Treadway Commission. As a result of this assessment, management has concluded that the Company's internal control over financial reporting was effective as of December 31, 2018.

Moss Adams 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. Moss Adams LLP was also engaged to audit the effectiveness of the Company's internal control over financial reporting. The report of Moss Adams 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

Table of Contents

Report of Independent Registered Public Accounting Firm

To the Shareholders and the Board of Directors of
Farmers & Merchants Bancorp

Opinions on the Financial Statements and Internal Control over Financial Reporting

We have audited the accompanying consolidated balance sheets of Farmers & Merchants Bancorp and subsidiaries (the “Company”) as of December 31, 2018 and 2017, the related consolidated statements of income, comprehensive income, changes in shareholders’ equity and cash flows for each of the three years in the period ended December 31, 2018, and the related notes (collectively referred to as the “consolidated financial statements”). We also have audited the Company’s internal control over financial reporting as of December 31, 2018, based on criteria established in Internal Control - Integrated Framework 2013 issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of the Company as of December 31, 2018 and 2017, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 2018, in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2018, based on criteria established in Internal Control - Integrated Framework 2013 issued by COSO.

Basis for Opinions

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 included in Item 8. Our responsibility is to express an opinion on the Company’s consolidated financial statements and an opinion on the Company’s internal control over financial reporting based on our audits. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) (“PCAOB”) and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. 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, whether due to error or fraud, and whether effective internal control over financial reporting was maintained in all material respects.

Our audits of the consolidated financial statements included performing procedures to assess the risks of material misstatement of the consolidated financial statements, whether due to error or fraud, and performing procedures to respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the consolidated financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements. 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.

67

Table of Contents

Definition and Limitations of Internal Control Over Financial Reporting

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.

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.

/s/ Moss Adams LLP

Los Angeles, California
March 15, 2019

We have served as the Company's auditor since 2013.

Table of Contents

Farmers & Merchants Bancorp

Consolidated Balance Sheets
(in thousands except share and per share data)

	December 31, 2018	2017
Assets		
Cash and Cash Equivalents:		
Cash and Due from Banks	$61,058	$65,956
Interest Bearing Deposits with Banks	84,506	121,193
Total Cash and Cash Equivalents	145,564	187,149
Investment Securities:		
Available-for-Sale	495,396	481,596
Held-to-Maturity	53,566	54,460
Total Investment Securities	548,962	536,056
Loans & Leases:	2,571,241	2,215,295
Less: Allowance for Credit Losses	55,266	50,342
Loans& Leases, Net	2,515,975	2,164,953
Premises and Equipment, Net	32,623	28,679
Bank Owned Life Insurance, Net	65,117	59,583
Interest Receivable and Other Assets	126,002	99,032
Total Assets	$3,434,243	$3,075,452
Liabilities		
Deposits:		
Demand	$974,756	$832,652
Interest-Bearing Transaction	694,384	601,476
Savings and Money Market	903,665	813,703
Time	490,027	475,397
Total Deposits	3,062,832	2,723,228
Subordinated Debentures	10,310	10,310
Interest Payable and Other Liabilities	49,886	42,254
Total Liabilities	3,123,028	2,775,792
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 Shares Authorized, 783,721 and 812,304 Shares Issued and Outstanding at December 31, 2018 and 2017, respectively.	8	8
Additional Paid-In Capital	72,974	93,624
Retained Earnings	241,221	206,845
Accumulated Other Comprehensive Loss	(2,988)	(817)
Total Shareholders' Equity	311,215	299,660
Total Liabilities and Shareholders' Equity	$3,434,243	$3,075,452

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

69

Table of Contents

Farmers & Merchants Bancorp

Consolidated Statements of Income
(in thousands except per share data)

	Year Ended December 31,		
	2018	2017	2016
Interest Income			
Interest and Fees on Loans & Leases	$119,837	$102,682	$91,570
Interest on Deposits with Banks	2,755	2,060	287
Interest on Investment Securities:			
Taxable	9,257	8,123	5,505
Exempt from Federal Tax	1,604	1,747	1,904
Total Interest Income	133,453	114,612	99,266
Interest Expense			
Deposits	7,425	5,865	3,807
Borrowed Funds	1	-	18
Subordinated Debentures	524	424	371
Total Interest Expense	7,950	6,289	4,196
Net Interest Income	125,503	108,323	95,070
Provision for Credit Losses	5,533	2,850	6,335
Net Interest Income After Provision for Credit Losses	119,970	105,473	88,735
Non-Interest Income			
Service Charges on Deposit Accounts	3,479	3,453	3,376
Net (Loss) Gain on Investment Securities	(1,260)	131	(284)
Increase in Cash Surrender Value of Life Insurance	1,900	1,822	1,864
Debit Card and ATM Fees	4,365	3,873	3,398
Net Gain on Deferred Compensation Investments	1,088	2,563	1,999
Bargain Purchase Gain	-	-	1,832
Other	5,647	4,920	3,072
Total Non-Interest Income	15,219	16,762	15,257
Non-Interest Expense			
Salaries and Employee Benefits	50,054	45,746	41,981
Net Gain on Deferred Compensation Investments	1,088	2,563	1,999
Occupancy	3,905	3,543	2,985
Equipment	4,303	3,994	3,493
Marketing	1,232	1,027	1,191
Legal	968	424	966
FDIC Insurance	912	932	897
Gain on Sale of ORE	-	(414)	(5,941)
Acquisition Expenses	2,933	-	910
Other	10,064	9,939	9,691
Total Non-Interest Expense	75,459	67,754	58,172
Income Before Income Taxes	59,730	54,481	45,820
Provision for Income Taxes	14,203	26,111	16,097

Net Income	$45,527	$28,370	$29,723
Basic and Diluted Earnings Per Common Share	$56.82	$35.03	$37.44

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

Table of Contents
FARMERS & MERCHANTS BANCORP

Consolidated Statements of Comprehensive Income
(in thousands)

	Year Ended December 31,		
	2018	2017	2016
Net Income	$45,527	$28,370	$29,723
Other Comprehensive Loss			
Net Unrealized Loss on Available-for-Sale Securities	(4,343)	(1,011)	(1,330)
Deferred Tax Benefit Related to Unrealized Losses	1,284	281	559
Reclassification Adjustment for Realized Loss (Gain) on Available-for-Sale Securities Included in Net Income	1,261	(131)	284
Tax (Benefit) Expense Related to Reclassification Adjustment	(373)	55	(119)
Change in Net Unrealized Loss on Available-for-Sale Securities, Net of Tax	(2,171)	(806)	(606)
Total Other Comprehensive Loss	(2,171)	(806)	(606)
Comprehensive Income	$43,356	$27,564	$29,117

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

Table of Contents
Farmers & Merchants Bancorp
Consolidated Statements of Changes in Shareholders' Equity
(in thousands except share and per share data)

	Common Shares Outstanding	Common Stock	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive (Loss) Income	Total Shareholders' Equity
Balance, January 1, 2016	790,787	$ 8	$ 81,164	$ 170,068	$ 595	$ 251,835
Net Income				29,723		29,723
Cash Dividends Declared on Common Stock ($13.10 per share)				(10,478)		(10,478)
Issuance of Common Stock	16,542		9,507			9,507
Change in Net Unrealized Gain on Securities Available-for-Sale					(606)	(606)
Balance, December 31, 2016	807,329	$ 8	$ 90,671	$ 189,313	$ (11)	$ 279,981
Net Income				28,370		28,370
Cash Dividends Declared on Common Stock ($13.55 per share)				(10,982)		(10,982)
Issuance of Common Stock	4,975		2,953			2,953
Tax Adjustment of Available-for-Sale Securities Reclassed from AOCI				144	(144)	-
Change in Net Unrealized Gain on Securities Available-for-Sale					(662)	(662)
Balance, December 31, 2017	812,304	$ 8	$ 93,624	$ 206,845	$ (817)	$ 299,660
Net Income				45,527		45,527
Cash Dividends Declared on Common Stock ($13.90 per share)				(11,151)		(11,151)
Repurchase of Common Stock	(44,503)		(31,152)			(31,152)
Issuance of Common Stock	15,920		10,502			10,502
Change in Net Unrealized (Loss) on Securities Available-for-Sale					(2,171)	(2,171)
Balance, December 31, 2018	783,721	$ 8	$ 72,974	$ 241,221	$ (2,988)	$ 311,215

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

Table of Contents

Farmers & Merchants Bancorp
Consolidated Statements of Cash Flows
(in thousands)

	Year Ended December 31,		
	2018	2017	2016
Operating Activities			
Net Income	$45,527	$28,370	$29,723
Adjustments to Reconcile Net Income to Net Cash Provided by Operating Activities:			
Provision for Credit Losses	5,533	2,850	6,335
Depreciation and Amortization	2,421	2,186	1,896
Provision for Deferred Income Taxes	5,462	12,605	(2,299)
Net Amortization of Investment Security Premium & Discounts	861	1,430	1,481
Amortization of Core Deposit Intangible	228	110	13
Accretion of Discount on Acquired Loans	(153)	(202)	(43)
Net Loss (Gain) on Investment Securities	1,260	(131)	284
Net (Gain) Loss on Sale of Property & Equipment	(273)	(1,189)	71
Net Gain on sale of ORE	-	(414)	(5,941)
Bargain Purchase Gain	-	-	(1,832)
Earnings from Equity Investment	(66)	-	-
Dividends from Equity Investment	63	-	-
Gain on Remeasurement of Previously Held Equity Investment	(997)	-	-
Net Change in Operating Assets & Liabilities:			
Net Decrease (Increase) in Interest Receivable and Other Assets	(2,098)	(275)	1,056
Net Increase (Decrease) in Interest Payable and Other Liabilities	6	(5,396)	4,068
Net Cash Provided by Operating Activities	57,774	39,944	34,812
Investing Activities			
Purchase of Investment Securities Available-for-Sale	(465,414)	(325,573)	(497,797)
Proceeds from Sold, Matured, or Called Securities Available-for-Sale	550,727	289,857	426,142
Purchase of Investment Securities Held-to-Maturity	(9,813)	(1,205)	(2,264)
Proceeds from Matured, or Called Securities Held-to-Maturity	10,647	4,794	5,499
Net Loans & Leases Paid, Originated or Acquired	(276,066)	(38,178)	(148,960)
Principal Collected on Loans & Leases Previously Charged Off	158	259	232
Cash (Paid) Received from Acquisition, Net	(5,987)	-	31,751
Additions to Premises and Equipment	(4,577)	(4,254)	(1,504)
Purchase of Other Investment	(5,750)	(14,380)	(6,825)
Proceeds from Sale of Property & Equipment	986	3,304	-
Proceeds from Sale of ORE	-	3,186	8,282
Net Cash Used in Investing Activities	(205,089)	(82,190)	(185,444)
Financing Activities			
Net Increase in Deposits	148,033	141,517	200,524
Stock Repurchases	(31,152)	-	-
Cash Dividends	(11,151)	(10,982)	(10,478)
Net Cash Provided by Financing Activities	105,730	130,535	190,046
Increase (Decrease) in Cash and Cash Equivalents	(41,585)	88,289	39,414
Cash and Cash Equivalents at Beginning of Year	187,149	98,860	59,446
Cash and Cash Equivalents at End of Year	$145,564	$187,149	$98,860
Supplementary Data			
Loans Transferred to Foreclosed Assets (ORE)	$-	$-	$538

Cash Payments Made for Income Taxes	$7,971	$13,942	$12,891
Issuance of Common Stock to the Bank’s Non-Qualified Retirement Plans	$10,502	$2,953	$2,586
Interest Paid	$7,731	$6,005	$3,856
Acquisitions:			
Fair Value of Assets Acquired	$234,456	$-	$114,871
Fair Value of Liabilities Acquired	$192,809	$-	$103,861
Issuance of Common Stock to Acquired Bank’s Shareholders	$-	$-	$6,921

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

73

Table of Contents
Notes to Consolidated Financial Statements

1.Significant Accounting Policies

Farmers & Merchants Bancorp (the "Company") was organized March 10, 1999. Primary operations are related to traditional banking activities through its subsidiary Farmers & Merchants Bank of Central California (the "Bank") which was established in 1916. The Bank's wholly owned subsidiaries include Farmers & Merchants Investment Corporation and Farmers/Merchants Corp. Farmers & Merchants Investment Corporation has been dormant since 1991. Farmers/Merchants Corp. acts as trustee on deeds of trust originated by the Bank.

The Company's other wholly owned subsidiaries include F & M Bancorp, Inc. and FMCB Statutory Trust I. 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. In December 2003, the Company formed a wholly owned subsidiary, FMCB Statutory Trust I, for the sole purpose of issuing Trust Preferred Securities and related subordinated debentures, in accordance with generally accepted accounting principles in the United States ("U.S. GAAP"). FMCB Statutory Trust I is a non-consolidated subsidiary.

On October 10, 2018, Farmers & Merchants Bancorp completed the acquisition of the Bank of Rio Vista, headquartered in Rio Vista, California, a locally owned and operated community bank established in 1904. As of the acquisition date, Bank of Rio Vista had approximately $217.5 million in assets and three branch locations in the communities of Rio Vista, Walnut Grove, and Lodi. Since the Company had a 39.65% interest in Bank of Rio Vista prior to the acquisition of the remaining interest, the transaction was accounted for as a business combination achieved in stages or a step acquisition. The Company, through an independent valuation, remeasured its previously held equity interest in Bank of Rio Vista at fair value, which resulted in a gain for the excess of the acquisition-date fair value over its carrying value of $997,000 which is included in other non-interest income in the consolidated statements of income. At the effective time of the acquisition, Bank of Rio Vista was merged into Farmers & Merchants Bank of Central California.

On November 18, 2016, Farmers & Merchants Bancorp completed the acquisition of Delta National Bancorp, headquartered in Manteca, California, and the parent holding company for Delta Bank N.A., a locally owned and operated community bank established in 1973. As of the acquisition date, Delta National Bancorp had approximately $112 million in assets and four branch locations in the communities of Manteca, Riverbank, Modesto and Turlock. At the effective time of the acquisition, Delta National Bancorp was merged into Farmers & Merchants Bancorp and Delta Bank, N.A. was merged into Farmers & Merchants Bank of Central California.

The accounting and reporting policies of the Company conform to U.S. GAAP and prevailing practice within the banking industry. The following is a summary of the significant accounting and reporting policies used in preparing the consolidated financial statements.

Basis of Presentation
The accompanying consolidated financial statements and notes thereto have been prepared in accordance with accounting principles generally accepted in the United States of America for financial information.

The accompanying consolidated financial statements include the accounts of the Company and the Company's wholly owned subsidiaries, F & M Bancorp, Inc. and the Bank, along with the Bank's wholly owned subsidiaries, Farmers & Merchants Investment Corporation and Farmers/Merchants Corp. Significant inter-company transactions have been eliminated in consolidation.

The preparation of consolidated financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions. These estimates and assumptions affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from these estimates.

Table of Contents

Certain amounts in the prior years' financial statements and related footnote disclosures have been reclassified to conform to the current-year presentation. These reclassifications had no effect on previously reported net income or total shareholders' equity.

Out of Period Adjustment

During the quarter ended September 30, 2018, while preparing 2017 tax returns, the Company identified certain items related to IRS Code Section 162(m) that were not appropriately reflected in the 2014 through 2017 Provision for Income Taxes. To reflect this change, the cumulative impact of $990,000 was recognized by reducing the Company's Provision for Income Taxes in the third quarter of 2018. After evaluating the quantitative and qualitative aspects of the adjustment, the Company concluded that its prior period financial statements were not materially misstated and, therefore, no restatement was required.

Revenue from Contracts with Customers

The Company records revenue from contracts with customers in accordance with Accounting Standards Codification Topic 606, "Revenue from Contracts with Customers" ("Topic 606"). Under Topic 606, the Company must identify the contract with a customer, identify the performance obligations in the contract, determine the transaction price, allocate the transaction price to the performance obligations in the contract, and recognize revenue when (or as) the Company satisfies a performance obligation. Significant revenue has not been recognized in the current reporting period that results from performance obligations satisfied in previous periods. The Company elected to use the modified retrospective transition method which requires application of ASU 2014-09 to uncompleted contracts at the date of adoption however, periods prior to the date of adoption will not be retrospectively revised as the impact of the ASU on uncompleted contracts at the date of adoption was not material.

The Company's primary sources of revenue are derived from interest and dividends earned on loans, investment securities, and other financial instruments that are not within the scope of Topic 606. The Company has evaluated the nature of its contracts with customers and determined that further disaggregation of revenue from contracts with customers into more granular categories beyond what is presented in the Consolidated Statements of Income was not necessary. The Company generally fully satisfies its performance obligations on its contracts with customers as services are rendered and the transaction prices are typically fixed; charged either on a periodic basis or based on activity. Because performance obligations are satisfied as services are rendered and the transaction prices are fixed, there is limited judgment involved in applying Topic 606 that significantly affects the determination of the amount and timing of revenue from contracts with customers.

Cash and Cash Equivalents

For purposes of the Consolidated Statements of Cash Flows, the Company has defined cash and cash equivalents as those amounts included in the balance sheet captions Cash and Due from Banks, Interest Bearing Deposits with Banks, Federal Funds Sold which have maturity dates of 3 months or less. For these instruments, the carrying amount is a reasonable estimate of fair value.

Investment Securities

Investment securities are classified at the time of purchase as held-to-maturity ("HTM") if it is management's intent and the Company has the ability to hold the securities until maturity. These securities are carried at cost, adjusted for amortization of premium and accretion of discount using a level yield of interest over the estimated remaining period until maturity. Losses, reflecting a decline in value judged by the Company to be other than temporary, are recognized in the period in which they occur.

Securities are classified as available-for-sale ("AFS") if it is management's intent, at the time of purchase, to hold the securities for an indefinite period of time and/or to use the securities as part of the Company's asset/liability management strategy. 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. Fair values are based on quoted market prices or broker/dealer price quotations on a specific identification basis. Gains or losses on the sale of these securities are computed using the specific identification method.

Trading securities, if any, are acquired for short-term appreciation and are recorded in a trading portfolio and are carried at fair value, with unrealized gains and losses recorded in non-interest income.

Table of Contents

Management evaluates securities for other-than-temporary impairment ("OTTI") on at least a quarterly basis, and more frequently when economic or market conditions warrant such an evaluation. For securities in an unrealized loss position, management considers the extent and duration of the unrealized loss, and the financial condition and near-term prospects of the issuer. Management also assesses whether it intends to sell, or it is more likely than not that it will be required to sell, a security in an unrealized loss position before recovery of its amortized cost basis. If either of the criteria regarding intent or requirement to sell is met, the entire difference between amortized cost and fair value is recognized as impairment through earnings. For debt securities that do not meet the aforementioned criteria, the amount of impairment is split into two components as follows: (1) OTTI related to credit loss, which must be recognized in the income statement; and (2) OTTI related to other factors, which is recognized in other comprehensive income. The credit loss is defined as the difference between the present value of the cash flows expected to be collected and the amortized cost basis. For equity securities, the entire amount of a market adjustment is recognized through earnings.

Securities Sold Under Agreement to Repurchase

Securities Sold Under Agreement to Repurchase are used as secured borrowing alternatives to FHLB Advances or FRB Borrowings.

Loans & Leases

Loans & leases are reported at the principal amount outstanding net of unearned discounts and deferred loan & lease fees and costs. Interest income on loans & leases is accrued daily on the outstanding balances using the simple interest method. Loan & lease origination fees are deferred and recognized over the contractual life of the loan or lease as an adjustment to the yield. Loans & leases are placed on non-accrual status when the collection of principal or interest is in doubt or when they become past due for 90 days or more unless they are both well-secured and in the process of collection. For this purpose, a loan or lease is considered well-secured if it is collateralized by property having a net realizable value in excess of the amount of the loan or lease or is guaranteed by a financially capable party. When a loan or lease is placed on non-accrual status, the accrued and unpaid interest receivable is reversed and charged against current income; thereafter, interest income is recognized only as it is collected in cash. Additionally, cash would be applied to principal if all principal was not expected to be collected. Loans & leases placed on non-accrual status are returned to accrual status when the loans or leases are paid current as to principal and interest and future payments are expected to be made in accordance with the contractual terms of the loan or lease.

A loan or lease is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts due, including principal and interest, according to the contractual terms of the original agreement. Impaired loans & leases are either: (1) non-accrual loans & leases; or (2) restructured loans & leases that are still accruing interest. Loans or leases determined to be impaired are individually evaluated for impairment. When a loan or lease is impaired, the Company measures impairment based on the present value of expected future cash flows discounted at the loan or lease's effective interest rate, except that as a practical expedient, it may measure impairment based on a loan or lease's observable market price, or the fair value of the collateral if the loan or lease is collateral dependent. A loan or lease is collateral dependent if the repayment of the loan or lease is expected to be provided solely by the underlying collateral.

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

Table of Contents

Generally, the Company will not restructure loans or leases for borrowers unless: (1) the existing loan or lease is brought current as to principal and interest payments; and (2) the restructured loan or lease 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 or lease amounts. After restructure, a determination is made whether the loan or lease will be kept on accrual status based upon the underwriting and historical performance of the restructured credit.

Allowance for Credit Losses

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

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

The Company maintains a separate allowance for each portfolio segment (loan & lease type). These portfolio segments include: (1) commercial real estate; (2) agricultural real estate; (3) real estate construction (including land and development loans); (4) residential 1st mortgages; (5) home equity lines and loans; (6) agricultural; (7) commercial; (8) consumer and other; and (9) equipment leases. The allowance for credit losses attributable to each portfolio segment, which includes both individually evaluated impaired loans & leases and loans & leases that are collectively evaluated for impairment, is combined to determine the Company's overall allowance, which is included on the consolidated balance sheet.

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

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

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

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

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

Table of Contents

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

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

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

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

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

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

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

Residential 1st Mortgages and Home Equity Lines and Loans – These loans are generally considered to possess a low inherent risk of loss, although this is not always true as evidenced by the correction in residential real estate values that occurred between 2007 and 2012. The degree of risk in residential real estate lending depends primarily on the loan amount in relation to collateral value, the interest rate and the borrower's ability to repay in an orderly fashion. Economic trends determined by unemployment rates and other key economic indicators are closely correlated to the credit quality of these loans. Weak economic trends indicate that the borrowers' capacity to repay their obligations may be deteriorating.

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

At least quarterly, the Board of Directors reviews the adequacy of the allowance, including consideration of the relative risks in the portfolio, current economic conditions and other factors. If the Board of Directors and management determine that changes are warranted based on those reviews, the allowance is adjusted. In addition, the Company's and Bank's regulators, including the Federal Reserve Board ("FRB"), the California Department of Business Oversight ("DBO") and the Federal Deposit Insurance Corporation ("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.

Table of Contents

Acquired Loans

Loans acquired through purchase or through a business combination are recorded at their fair value at the acquisition date. Credit discounts, which reflect estimates of credit losses, expected to be incurred over the life of the loan, are included in the determination of fair value; therefore, an allowance for loan losses is not recorded at the acquisition date.

Allowance for Credit Losses on Off-Balance-Sheet Credit Exposures

The Company also maintains a separate allowance for off-balance-sheet commitments. Management estimates anticipated losses using historical data and utilization assumptions. The allowance for off-balance-sheet commitments is included in Interest Payable and Other Liabilities on the Company’s Consolidated Balance Sheet.

Premises and Equipment

Premises, equipment, and leasehold improvements are stated at cost, less accumulated depreciation and amortization. Depreciation is computed principally by the straight-line method over the estimated useful lives of the assets. Estimated useful lives of buildings range from 30 to 40 years, and for furniture and equipment from 3 to 7 years. Leasehold improvements are amortized over the lesser of the terms of the respective leases, or their useful lives, which are generally 5 to 10 years. Remodeling and capital improvements are capitalized while maintenance and repairs are charged directly to occupancy expense.

Other Real Estate

Other real estate, which is included in other assets, is expected to be sold and is comprised of properties no longer utilized for business operations and property acquired through foreclosure in satisfaction of indebtedness. These properties are recorded at fair value less estimated selling costs upon acquisition. Revised estimates to the fair value less cost to sell are reported as adjustments to the carrying amount of the asset, provided that such adjusted value is not in excess of the carrying amount at acquisition. Initial losses on properties acquired through full or partial satisfaction of debt are treated as credit losses and charged to the allowance for credit losses at the time of acquisition. Subsequent declines in value from the recorded amounts, routine holding costs, and gains or losses upon disposition, if any, are included in non-interest expense as incurred.

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.

The Company follows the standards set forth in the “Income Taxes” topic of the Financial Accounting Standards Board (“FASB”) Accounting Standard Codification (“ASC”), which clarifies the accounting for uncertainty in income taxes recognized in an enterprise’s financial statements. This standard prescribes a recognition threshold and measurement standard for the financial statement recognition and measurement of an income tax position taken or expected to be taken in a tax return. It also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition.

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

The Company accounts for its interest in LIHTC using the cost method as established in ASC 323-740. As an investor, the Company obtains income tax credits and deductions from the operating losses of these tax credit entities. The income tax credits and deductions are allocated to the investors based on their ownership percentages and are recorded as a reduction of income tax expense (or an increase to income tax benefit) and a reduction of federal income taxes payable.

Table of Contents

When tax returns are filed, it is highly certain that some positions taken would be sustained upon examination by the taxing authorities, while others are subject to uncertainty about the merits of the position taken or the amount of the position that would be ultimately sustained. The benefit of a tax position is recognized in the financial statements in the period during which, based on all available evidence, management believes it is more likely than not that the position will be sustained upon examination, including the resolution of appeals or litigation processes, if any. Tax positions taken are not offset or aggregated with other positions. Tax positions that meet the more-likely-than-not recognition threshold are measured as the largest amount of tax benefit that is more than 50 percent likely of being realized upon settlement with the applicable taxing authority. The portion of the benefits associated with tax positions taken that exceeds the amount measured as described above is reflected as a liability for unrecognized tax benefits in the accompanying consolidated balance sheet along with any associated interest and penalties that would be payable to the taxing authorities upon examination.

At December 31, 2018 and 2017, the Company has no material uncertain tax positions and recognized no interest or penalties. The Company's policy is to recognize interest and penalties related to income taxes in the provision for income taxes in the Consolidated Statement of Income.

Basic and Diluted Earnings Per Common Share

The Company's common stock is not traded on any exchange. The shares are primarily held by local residents and are not actively traded. Basic earnings per common share amounts are computed by dividing net income by the weighted average number of common shares outstanding for the period. There are no common stock equivalent shares. Therefore, there is no presentation of diluted basic earnings per common share. See Note 15 for additional information.

Segment Reporting

The "Segment Reporting" topic of the FASB ASC requires that public companies report certain information about operating segments. It also requires that public companies report certain information about their products and services, the geographic areas in which they operate, and their major customers. The Company is a holding company for a community bank, which offers a wide array of products and services to its customers. Pursuant to its banking strategy, emphasis is placed on building relationships with its customers, as opposed to building specific lines of business. As a result, the Company is not organized around discernible lines of business and prefers to work as an integrated unit to customize solutions for its customers, with business line emphasis and product offerings changing over time as needs and demands change.

Comprehensive Income

The "Comprehensive Income" topic of the FASB ASC establishes standards for the reporting and display of comprehensive income and its components in the financial statements. Other comprehensive income refers to revenues, expenses, gains, and losses that U.S. GAAP recognize as changes in value to an enterprise but are excluded from net income. For the Company, comprehensive income includes net income and changes in fair value of its available-for-sale investment securities.

Loss Contingencies

Loss contingencies, including claims and legal actions arising in the ordinary course of business, are recorded as liabilities when the likelihood of loss is probable and an amount or range of loss can be reasonably estimated. Management does not believe there now are such matters that will have a material effect on the financial statements.

Business Combinations And Related Matters

Business combinations are accounted for under the acquisition method of accounting in accordance with ASC 805, Business Combinations. Under the acquisition method, the acquiring entity in a business combination recognizes 100 percent of the acquired assets and assumed liabilities, regardless of the percentage owned, at their estimated fair values as of the date of acquisition. Any excess of the fair value over the purchase price of net assets and other identifiable intangible assets acquired is recorded as bargain purchase gain. Assets acquired and liabilities assumed from contingencies must also be recognized at fair value, if the fair value can be determined during the measurement period. Results of operations of an acquired business are included in the statement of operations from the date of acquisition. Acquisition-related costs, including conversion charges, are expensed as incurred.

Table of Contents

Goodwill and Other Intangible Assets: Goodwill is determined as the excess of the fair value of the consideration transferred, plus the fair value of any noncontrolling interests in the acquiree, over the fair value of the net assets acquired and liabilities assumed as of the acquisition date. Goodwill that arises from a business combination is periodically evaluated for impairment at the reporting unit level, at least annually. Intangible assets with definite useful lives are amortized over their estimated useful lives to their estimated residual values. Core deposit intangible ("CDI") represents the estimated future benefit of deposits related to an acquisition and is booked separately from the related deposits and evaluated periodically for impairment. The CDI asset is amortized on a straight-line method over its estimated useful life of ten years. At December 31, 2018, the future estimated amortization expense for the CDI arising from our past acquisitions is as follows:

(in thousands)	2019	2020	2021	2022	2023	Thereafter	Total
Core Deposit Intangible Amortization	$639	$626	$611	$593	$573	$ 2,236	$5,278

We make a qualitative assessment of whether it is more likely than not that the fair value of a reporting unit where goodwill is assigned is less than its carrying amount. If we conclude that it is more likely than not that the fair value is more than its carrying amount, no impairment is recorded. Goodwill is tested for impairment on an interim basis if circumstances change or an event occurs between annual tests that would more likely than not reduce the fair value of the reporting unit below its carrying amount. The qualitative assessment includes adverse events or circumstances identified that could negatively affect the reporting units' fair value as well as positive and mitigating events. Such indicators may include, among others, a significant change in legal factors or in the general business climate, significant change in our stock price and market capitalization, unanticipated competition, and an action or assessment by a regulator. If the fair value of a reporting unit is less than its carrying amount, an impairment charge for the amount by which the carrying amount exceeds the reporting unit's fair value is recognized. The loss recognized should not exceed the total amount of goodwill allocated to that reporting unit.

2. Business Combinations

Bank of Rio Vista

On April 5, 2017, the Company purchased 4.9% of the voting shares of Bank of Rio Vista (BRV). On July 3, 2017, the Federal Reserve Bank of San Francisco approved the Company's application to acquire additional voting shares and between July 2017 and March 2018 the Company acquired shares bringing its total to 39.65% of the outstanding shares. Initially, the Company, as per requirements outlined in ASC 323-10-15-6, did not have the ability to exercise significant influence over BRV's operating and financial policies. Accordingly, the investment in BRV was accounted for under the cost method of accounting until March 26, 2018 when the Company entered into a definitive agreement for the acquisition of the remaining 60.35% of the voting shares of Bank of Rio Vista, at which time it changed to the equity method of accounting retroactive to January 1, 2018. On October 10, 2018, the Company completed the acquisition of the remaining shares.

Bank of Rio Vista was incorporated under the laws of the State of California on April 12, 1904, and operated as a commercial bank with branches in the cities of Rio Vista, Walnut Grove, and Lodi, California. The acquisition enhances our market presence and added $80.5 million in loans, $191.6 million in deposits and $104.1 million in investment securities to the Company. Effective November 30, 2018, the Lodi branch was closed after Management determined that our customers and the business community could be easily supported from our current Lodi locations. The assets acquired and liabilities assumed, both tangible and intangible, were recorded at their fair values as of the acquisition date in accordance with ASC 805, Business Combinations. The acquisition was treated as a "reorganization" within the meaning of section 368(a)(1)(A) of the Internal Revenue Code and is considered tax-free for U.S. federal income tax purposes.

Table of Contents

The following table reflects the book value and estimated fair value of the assets acquired and liabilities assumed related to the Bank of Rio Vista acquisition:

(in thousands)	Bank of Rio Vista Book Value	Fair Value
Assets Acquired:		
Cash and Cash Equivalents	$22,655	$22,655
Investments	104,118	104,118
Loans	78,437	80,494
Core Deposit Intangible	-	4,670
Goodwill	-	11,183
Deferred Tax	2,813	298
Other Assets	9,470	11,038
Total Assets Acquired	$217,493	$234,456
Liabilities Assumed		
Deposits:		
Demand	54,450	54,450
Interest-Bearing Transaction	48,469	48,469
Savings and Money Market	62,839	62,839
Time	25,813	25,813
Total Deposits	$191,571	$191,571
Other Liabilities	1,238	1,238
Total liabilities assumed	$192,809	$192,809
Cash Paid		28,642
Value of Previously Held Equity Interest		13,005
Total Merger Consideration		$41,647

The following table presents the net assets acquired from Bank of Rio Vista and the estimated fair value adjustment:

(in thousands)	Acquisition Date October 10, 2018
Book Value of Net Assets Acquired	$ 24,684
Fair Value Adjustments:	
Loans	440
Reversal of Allowance for Loan Loss	1,616
Core Deposit Intangible Asset	4,670
Other Assets & Liabilities, net	1,568
Total Purchase Accounting Adjustments	$ 8,294
Deferred Tax Asset (tax effect of purchase accounting adjustments at 29.56%)	(2,452)
DTA Adjustment	(62)
Fair Value of Net Assets Acquired	$ 30,464
Merger Consideration	41,647
Fair Value of Net Assets Acquired	(30,464)

Goodwill	$ 11,183

The following is a description of the methods used to determine the fair value of significant assets and liabilities presented above.

Table of Contents

Cash and Cash Equivalents: The carrying amount for cash and due from banks, interest-bearing deposits with banks and federal funds sold are a reasonable estimate of fair value based on the short-term nature of these assets.

Investments: Fair value for investments was obtained from an independent pricing service. The fair value measurements consider observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution data, market consensus prepayment spreads, credit information and the bond's terms and conditions.

Loans: Fair value for loans were based on a discounted cash flow methodology that considered factors including the type of loan and related collateral, classification status, fixed or variable interest rate, term of loan, and amortization status. Loans were individually assessed, with some assumptions being applied from the aggregate pool level to the individual loan itself. The discount rates used for loans are based on a build-up method that considers credit ratings, funding, liquidity, and other adjustments. No credit impaired loans were acquired as part of this business combination.

Core Deposit Intangible (CDI): This intangible asset represents the value of the relationships with deposit customers. The fair value was estimated based on a discounted cash flow methodology that gave appropriate consideration to expected customer attrition rates, cost the deposit base, reserve requirements and the net maintenance cost attributable to customer deposits. The CDI is being amortized over 10 years based on the estimated economic benefits received.

The Company recorded a core deposit intangible asset acquisition of $4.7 million which $120 thousand was amortized in 2018. At December 31, 2018, the future estimated amortization expense on the CDI from the Bank of Rio Vista acquisition is as follows:

(in thousands)	**2019**	**2020**	**2021**	**2022**	**2023**	**Thereafter**	**Total**
Core Deposit Intangible Amortization	$533	$524	$512	$499	$481	$ 2,001	$4,550

Other Assets: Other assets are composed of real property assets which include two bank premises. These assets were valued in November 13, 2018 via USPAP-compliant appraisals for the 100% interest in the fee simple estate by a state licensed appraiser.

Deposits: The fair values used for the demand and savings deposits by definition equal the amount payable on demand at the acquisition date. The fair values for time deposits are estimated using a discounted cash flow calculation that applies interest rates currently being offered to the contractual interest rates on such time deposits.

The merger consideration is $41.65 million, which includes $28.6 million in cash, to purchase the remaining 2,414 (60.35%) shares outstanding as of October 10, 2018 plus the value of existing 39.65% investment of $13.0 million. The existing holdings were revalued at $8,200 per share based upon valuations completed during the quarter of issuance by a nationally recognized bank consulting and advisory firm.

The Company incurred acquisition-related expenses in 2018 for the Bank of Rio Vista acquisition as follows:

(in thousands)	Year Ended December 31, 2018
Data Processing	$ 1,978
Professional Services	950
Other	5
Total	$ 2,933

Table of Contents

3. Investment Securities

The amortized cost, fair values, and unrealized gains and losses of the securities available-for-sale are as follows: (in thousands)

	Amortized	Gross Unrealized		Fair/Book
December 31, 2018	Cost	Gains	Losses	Value
Government Agency & Government-Sponsored Entities	$ 3,033	$ 6	$ -	$ 3,039
US Treasury Notes	164,672	-	158	164,514
US Govt SBA	15,601	6	160	15,447
Mortgage Backed Securities [1]	310,982	1,196	5,133	307,045
Other	5,351	-	-	5,351
Total	$ 499,639	$ 1,208	$ 5,451	$ 495,396

	Amortized	Gross Unrealized		Fair/Book
December 31, 2017	Cost	Gains	Losses	Value
Government Agency & Government-Sponsored Entities	$ 3,080	$ 48	$ -	$ 3,128
US Treasury Notes	144,606	-	442	144,164
US Govt SBA	29,559	29	208	29,380
Mortgage Backed Securities [1]	302,502	939	1,527	301,914
Other	3,010	-	-	3,010
Total	$ 482,757	$ 1,016	$ 2,177	$ 481,596

[1] All Mortgage Backed Securities were issued by an agency or government sponsored entity of the U.S. government.

The book values, estimated fair values and unrealized gains and losses of investments classified as held-to-maturity are as follows: (in thousands)

	Book	Gross Unrealized		Fair
December 31, 2018	Value	Gains	Losses	Value
Obligations of States and Political Subdivisions	$53,566	$ 211	$ 39	$53,738
Total	$53,566	$ 211	$ 39	$53,738

	Book	Gross Unrealized		Fair
December 31, 2017	Value	Gains	Losses	Value
Obligations of States and Political Subdivisions	$54,460	$ 776	$ -	$55,236
Total	$54,460	$ 776	$ -	$55,236

Fair values are based on quoted market prices or dealer quotes. If a quoted market price or dealer quote is not available, fair value is estimated using quoted market prices for similar securities.

Table of Contents

The amortized cost and estimated fair values of investment securities at December 31, 2018 by contractual maturity are shown in the following tables. (in thousands)

December 31, 2018	Available-for-Sale Amortized Cost	Available-for-Sale Fair/Book Value	Held-to-Maturity Book Value	Held-to-Maturity Fair Value
Within One Year	$156,840	$ 156,751	$2,340	$ 2,342
After One Year Through Five Years	17,097	17,032	2,161	2,162
After Five Years Through Ten Years	1,474	1,472	21,167	21,292
After Ten Years	13,247	13,096	27,898	27,942
	188,658	188,351	53,566	53,738
Investment Securities Not Due at a Single Maturity Date:				
Mortgage Backed Securities	310,981	307,045	-	-
Total	$499,639	$ 495,396	$53,566	$ 53,738

Expected maturities of mortgage-backed securities may differ from contractual maturities because borrowers have the right to call or prepay obligations with or without call or prepayment penalties.

The following tables show those investments with gross unrealized losses and their market value aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at the dates indicated. (in thousands)

December 31, 2018	Less Than 12 Months Fair Value	Less Than 12 Months Unrealized Loss	12 Months or More Fair Value	12 Months or More Unrealized Loss	Total Fair Value	Total Unrealized Loss
Securities Available-for-Sale						
US Treasury Notes	$ 124,985	$ 7	$39,529	$ 151	$164,514	$ 158
US Govt SBA	3,250	28	8,618	132	11,868	160
Mortgage Backed Securities	52,289	528	207,271	4,605	259,560	5,133
Total	$ 180,524	$ 563	$255,418	$ 4,888	$435,942	$ 5,451
Securities Held-to-Maturity						
Obligations of States and Political Subdivisions	$ 6,052	$ 23	$849			