



SMALL BANK

Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

PUBLIC DISCLOSURE

March 19, 2012

COMMUNITY REINVESTMENT ACT PERFORMANCE EVALUATION

The Merchants National Bank of Sacramento
Charter Number 11875

1015 Seventh Street
Sacramento, CA 95814-0000

Office of the Comptroller of the Currency

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NOTE: This document is an evaluation of this institution's record of meeting the credit needs of its entire community, including low- and moderate-income neighborhoods consistent with safe and sound operation of the institution. This evaluation is not, nor should it be construed as, an assessment of the financial condition of this institution. The rating assigned to this institution does not represent an analysis, conclusion, or opinion of the federal financial supervisory agency concerning the safety and soundness of this financial institution.

INSTITUTION'S CRA RATING: This institution is rated Satisfactory.

The Merchants National Bank satisfactorily meets the credit needs of its assessment area (AA), including low-and moderate-income areas, consistent with its resources and capabilities. The following supports this rating:

- The bank's lending in its AA exceeds the standard for satisfactory performance.
- The bank's distribution of loans to businesses of different sizes meets the standard for satisfactory performance.
- The bank's geographic distribution of loans exceeds the standards for satisfactory performance.
- The bank's loan-to-deposit ratio meets the standard for satisfactory performance given the bank's continued efforts of meeting identified credit needs through community development loans and investments.
- There were no public complaints about the bank's CRA performance.

SCOPE OF EXAMINATION

We evaluated the bank's performance based on loans originated from January 1, 2009, through December 31, 2011. We focused our evaluation on the bank's primary product line, commercial loans (grouped under the title "business loans") originated during the past three years. We randomly selected 20 loans for our sample to review the bank's lending within its assessment area. We increased our sample, as necessary, to ensure we had a sample of 20 loans granted within the assessment area to review the income and geographic distributions of its loans, and its overall CRA performance. Home mortgage loan products were not selected in our sample since the bank is not a major mortgage lender. The bank also voluntarily provided information about its community development activities.

DESCRIPTION OF INSTITUTION

The Merchants National Bank (MNB or bank) is a community bank founded in 1921 and is headquartered in Sacramento, California. MNB is a wholly owned subsidiary of Merchants Holding Company, a unit bank holding company located in Sacramento, CA.

MNB provides full service banking through its headquarters office and branch located in the city of Carmichael. The bank has two other limited hours branches in Sacramento and Roseville. While the bank's primary loan product is business loans, consumer and home mortgage products are also available.

The bank's last CRA examination was dated August 15, 2005, with a satisfactory rating. There are no legal or financial factors that impede the bank's ability to help meet the

credit needs of its community. As of December 31, 2011, MNB had total assets of \$185 million with \$60 million in loans, which represents net loans to total assets of 32%.

Please refer to the bank’s CRA public file for more information about the institution.

DESCRIPTION OF ASSESSMENT AREA(S)

The bank’s AA meets the regulation’s requirement and does not arbitrarily exclude low- or moderate-income geographies. It includes all 279 contiguous census tracts in Sacramento County, which is part of the larger Sacramento-Arden-Arcade-Roseville Metropolitan Statistical Area (MSA). According to the 2000 U.S. Census data, low- and moderate-income census tracts represented 38.4% of all census tracts in Sacramento County. The U.S Census Bureau estimated the 2010 population of the AA to be 1,418,788, an increase of 16.0% since the 2000 Census. The following table provides additional information about the demographics of Sacramento County.

Demographic Information for Full Scope Area: Sacramento County					
Demographic Characteristics	#	Low % of #	Moderate % of #	Middle % of #	Upper % of #
Geographies (Census Tracts/BNAs)	279	9.32	29.03	36.92	24.73
Population by Geography	1,223,499	8.88	30.36	35.53	25.23
Owner-Occupied Housing by Geography	263,811	4.82	23.39	38.23	33.56
Business by Geography	133,073	8.00	24.66	34.36	32.98
Farms by Geography	2,314	6.01	22.47	38.42	33.10
Family Distribution by Income Level	299,738	22.88	19.20	20.94	36.98
Distribution of Low and Moderate Income Families throughout AA Geographies	126,121	13.51	40.60	32.93	12.96
Median Family Income		53,805	Median Housing Value		146,187
HUD Adjusted Median Family Income for 2011		75,100	Unemployment Rate (2000 US Census)		3.18%
Households Below Poverty Level		11%			

Source: 2000 US Census and 2011 HUD updated MFI

The bank faces strong competition from 36 banks operating within the assessment area. MNB ranks 18th in deposit market share with a market share of 0.77%. The five largest banks hold a total of 72.0% of total deposit market share in Sacramento County. The top five institutions are Wells Fargo Bank, U S Bank, Bank of America, JPMorgan Chase, and Citibank.

A recent community contact interview with a representative from a community development organization stated several opportunities exist, such as affordable housing development in rural communities, contributions to the operating budgets of nonprofit housing developers, and financing development projects in rural areas. The projects may be housing related or community facilities-all with the use of government guarantees through the USDA.

Please refer to the bank's CRA public file for more information about the assessment area.

DETERMINATION OF PRIMARY LOAN PRODUCTS

Table 1 reflects the bank's loan portfolio by number and dollar volume.

Table 1

The Merchants National Bank Loan Portfolio Composition As of 12/31/2011		
Loan Type	Dollar (000)*	Percentage
Business/Commercial Loans	34,026	57.0%
Residential Mortgage Loans	25,178	42.2%
Consumer Loans	434	0.7%
Farm Loans	46	0.1%
TOTAL	83,481	100.0%

Source: Call Report as of 12/31/11

*Reflects total commitment amount.

Commercial real estate and business lending makes up the majority of the bank's lending activity. While residential mortgage volume has increased over the past few years as a percentage of total loans, this type of lending is not considered a primary loan product. In addition, the bank generates less than 10 residential mortgages each year. Residential mortgage loans have a much longer term than commercial loans and the bank does not sell its loans in the secondary market. The bank's residential mortgage lending volume does not necessarily represent new loan activity but rather a building up of such loans in its portfolio. In fact, new residential mortgage loans have been steadily declining year over year for the past three years. As such, our analysis is focused on the bank's commercial real estate and other commercial lending activities, which we will refer to as "business lending" for purposes of this evaluation.

We analyzed a random selection of business loans for this performance evaluation. We analyzed loans originated between January 1, 2009 and December 31, 2011. We compared this lending to the 2000 U.S. Census demographic data and the 2010 Small Business aggregate, the most current peer data available.

CONCLUSIONS WITH RESPECT TO PERFORMANCE CRITERIA

Loan-to-Deposit Ratio

The bank's level of lending is reasonable given the bank's size, area credit needs, and the competitive banking market. The bank's low quarterly and average loan-to-deposit ratios (LTD) are mitigated by the bank's continued efforts of meeting identified credit needs in low and moderate income areas through lending-related qualified investments.

We analyzed the bank's quarterly LTD ratio from June 2005 through December 2011. During this period, the LTD ranged from a low of 25.3% to a high of 40.7%, with an average of 34.3%. We compared the bank's average ratio to that of four peer banks of comparable asset size that operate in the same assessment area. The peer group's average quarterly LTD ranged between 57.7% and 97.6% over the same time period. The bank's average ratio was consistently lower than the peer group averages but the bank's ratios overall have been improving while the peer averages have declined over the past three years.

Historically, the bank has maintained very high credit standards, which have resulted in lower than average loan production. The bank is a portfolio lender, therefore, it does not sell loans in the secondary market. As the composition of assets illustrate, 42% of the bank's loan assets are residential mortgage loans that have 30 year terms. Financial institutions that engage in secondary market activities can continue to grant more loans as they sell newly originated mortgages to third-parties. The bank continues with its marketing efforts to increase loan production and has seen some success but struggles to compete with 35 other financial institutions, including the large national lenders such as, Wells Fargo, US Bank, Bank of America and large regional banks, like Bank of the West and Union Bank.

The bank's loan volume has grown 28.5% since 2009 while its deposits have grown 44.8%. A combination of factors drove this deposit growth. Smaller community banks and credit unions have seen an increase in deposits as a result of flight from large banks or as a result of "flight to safety." In addition, as more and more banks eliminate "free checking" and low cost/low minimum balance deposit products, MNB continues to offer low-cost deposit products.

While the bank's conservative lending practices and lack of participation in the secondary mortgage markets hinders the bank's ability to lend back to the community at comparable levels as its deposits grow, the bank reinvests in its community through community development investments. The bank purchased \$12.5 million in U.S. Government Guaranteed Development Company Participation Certificates (DCPC) and U.S. Small Business Administration (SBA) Guaranteed Debenture Participation Certificates. These securities are backed by small business loans made by SBA-approved development companies and are guaranteed by the SBA. The U.S. Small Business Administration offers programs nationwide to assist in small business development.

Lending in Assessment Area

The bank’s record of lending within the AA exceeds the standard for satisfactory performance.

Table 2

Merchants National Bank Lending in the Sacramento-Arden-Arcade-Roseville MSA								
Loan Type	Number of Loans				Dollars of Loans			
	Inside		Outside		Inside		Outside	
	#	%	#	%	\$	%	\$	%
Business Loans	18	90%	2	10%	\$5,627,436	96%	\$220,000	4%
Totals	18	90%	2	10%	\$5,627,436	96%	\$220,000	4%

Source: Sample of 20 business loans originated from January 1, 2009 to December 31, 2011

For this performance criterion, we randomly sampled 20 business loans originated during the evaluation period and determined the percentage of those loans that were granted within the AA.

A substantial majority of the bank’s loans originated within its defined AA. Table 2 indicates the bank originated 90% of the number and 96% of the dollar volume of loans within the defined AA.

Lending to Borrowers of Different Incomes and to Businesses of Different Sizes

The bank’s distribution of loans to businesses of different sizes meets the standard for satisfactory performance. Businesses with annual revenues of \$1 million dollars or less are deemed to be small businesses.

Table 3

Revenue Distribution-Loans to Businesses Loans Originated between 2009 and 2011 Sacramento County				
Business Revenues (or Sales)	≤\$1,000,000	>\$1,000,000	Unavailable/Unknown	Total
% of AA Businesses	69.1%	2.6%	28.3%	100%
% of Bank Loans in AA by #	28.6%	71.4%	0.0%	100%

Demographic Data Source: 2011 Dun and Bradstreet Data

Our analysis included a randomly selected sample of 20 business loans originated within the bank’s AA. This sample included the 18 randomly selected loans analyzed under the **Lending In Assessment Area** section that were granted within the AA plus two additional randomly selected business loans originated within the bank’s AA. The following table displays the bank’s lending practices based on our loan sample of

business borrowers.

The bank’s lending to small businesses (businesses with annual revenues of \$1.0 million or less) represented only 28.6% of its business lending. These lending results were well below the demographics for small businesses in Sacramento County. The 2010 small businesses’ aggregate lending reflects 42.4 % of business loans granted to small businesses.

While the bank’s lending results are below both demographics for very small businesses and the 2010 peer aggregate results for lending to very small businesses, the bank’s lending involves a significant amount of community development. These are loans to businesses that provide jobs in low-income areas or to organizations that serve a community development purpose. For example, the bank granted a \$1.3 million loan to a community development organization that serves the homeless but whose revenues exceeded \$1.0 million. Further, as noted in the **Geographic Distribution of loans**, the bank extends credit in low-income census tracts at levels well above the demographics for businesses located in low-income census tracts.

Geographic Distribution of Loans

The bank's geographic distribution of loans exceeds the standard for satisfactory performance and reflects satisfactory dispersion throughout the AA.

Table 4

Geographic Distribution of Loans to Businesses Loans Originated Between 2009 and 2011 Sacramento County								
Census Tract Income Level	Low		Moderate		Middle		Upper	
	% of AA Businesses	% of Number of Loans						
2009-2011 Sample ¹	8.0%	50.0%	24.7%	7.1%	34.4%	35.7%	33.0%	7.1%

Demographic Data Source: ¹ 2011 Dun and Bradstreet

We reviewed the pattern for geographic distribution of lending in low- and moderate-income census tracts within the AA. Dun and Bradstreet demographics track where businesses are located based on U.S. Census information. Table 4 details the bank's business lending activity within the AA. We used the same sample of business loans from the **Lending to Businesses of Different Sizes** section of this performance evaluation.

The bank’s lending within low- and moderate-income census tracts represented 57.1% of its total business lending. This lending exceeds the percentage (32.7%) of businesses operating in low- or moderate-income census tracts. Further, the bank’s lending results exceed the 2010 small business aggregate’s low- and moderate-income census tract lending of 30.9%. The bank competes with 35 other banks, most of which

are larger and have more branches. The bank's deposit market share is 0.77%.

Responses to Complaints

The bank did not receive any complaints regarding its CRA performance during the review period.

Fair Lending or Other Illegal Credit Practices Review

We found no evidence of illegal discrimination or other illegal credit practices. There were no violations of the substantive provisions of the anti-discrimination laws and regulations identified. Based on this review, it was determined that the bank's compliance with fair lending laws is satisfactory.