



SMALL BANK

Comptroller of the Currency
Administrator of National Banks
Washington, DC 20219

PUBLIC DISCLOSURE

August 15, 2005

COMMUNITY REINVESTMENT ACT PERFORMANCE EVALUATION

**The Merchants National Bank of Sacramento
Charter Number 11875**

**1015 Seventh Street
Sacramento, CA 95814**

**Office of the Comptroller of the Currency
Western District
San Francisco Field Office
One Front Street, Suite 1000
San Francisco, CA 94111**

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 COMMUNITY REINVESTMENT ACT (CRA) RATING

This institution is rated **“SATISFACTORY.”**

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 meets the standards for satisfactory performance.
- While the bank’s loan-to-deposit ratio does not meet the standard for satisfactory performance, this is mitigated by the bank’s continued efforts of meeting identified credit needs in low and moderate income areas, through community development loans and lending-related qualified investments.
- There were no public complaints about the bank’s CRA performance.

DESCRIPTION OF INSTITUTION

Merchants National Bank (MNB) 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 does not have any ATM's. While the bank's primary loan product is business loans, consumer and home mortgage products are available.

The bank's last CRA examination was dated May 15, 2000, 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 June 30, 2005, MNB had total assets of \$123 million with \$27 million in loans, which represents net loans to total assets of 22%.

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

DESCRIPTION OF ASSESSMENT AREA

The bank’s AA meets the regulation’s requirement and does not arbitrarily exclude low- or moderate-income geographies. It includes 279 contiguous census tracts in Sacramento County, which is part of the Sacramento-Arden-Arcade-Roseville Metropolitan Statistical Area (MSA).

The 1990 U.S. Census data reflected low- and moderate-income tracts in the bank's AA to be 31.40%. When the 2000 U.S. Census data became effective in January 2003, the census tract designations changed and the low- and moderate- income tracts in the AA represented 38.35%. In January 2004, the Office of Management and Budget (OMB) changed the census tract designations again. However, this change only affected the middle and upper income tracts. This area's population is approximately 1,223,499 according to the 2000 U.S. Census data.

MNB faces strong competition from 42 banks operating within the assessment area. MNB ranks 26th in deposit market share with .41%. The five largest banks hold a total of 66% of the market share. The competing institutions include, in part, Bank of America, Wells Fargo Bank, U S Bank, Washington Mutual Bank, and World Savings Bank.

In conjunction with this CRA examination, we conducted a community contact interview with a representative from a community development organization to learn about credit opportunities within the community, and whether financial institutions address the credit and service needs of the community. The representative stated that there is an opportunity for local banks to participate in various CDFI Premium Tax Credit Programs and various economic development and affordable housing programs in the city of Sacramento.

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

DETERMINATION OF PRIMARY LOAN PRODUCTS

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

Table 1

| Merchants National Bank Loan Portfolio Composition | | | | |
|---|---------------|-------------------|---------------------|-------------------|
| Loan Type | Number | Percentage | Dollar* | Percentage |
| Business Loans | 74 | 56% | \$19,007,918 | 79% |
| Consumer Loans | 33 | 25% | \$854,181 | 4% |
| Home Loans | 21 | 16% | \$3,902,180 | 16% |
| Farm Loans | 5 | 3% | \$305,000 | 1% |
| TOTAL | 133 | 100% | \$24,069,279 | 100% |

Source: Bank data

**Reflects total commitment amount.*

Business loans are the bank's primary loan product based on dollar and number. As such, we analyzed a random selection of business loans for this performance evaluation. We analyzed loans originated between January 1, 2003 and July 31, 2005.

We compared loans originated between 2003 and 2005 to the 2000 U.S. Census data, which became effective in January 2003. At that time, the U.S. Census data changed boundaries and income levels of many existing census tracts, deleted some census tracts, and created new ones.

In 2004, the 2000 census data reflected updates from the U.S. Census Bureau and the Office of Management and Budget (OMB). These updates reflected new MSA definitions and boundaries. We compared loans that originated in 2004 and 2005 to the updated 2000 U.S. Census data.

CONCLUSIONS ABOUT PERFORMANCE CRITERIA

LENDING IN THE 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 31, 2003 to July 31, 2005

A substantial majority of the bank's loans originated within its defined AA. For this performance criterion, we randomly sampled 20 business loans originated during the evaluation period. Table 2 indicates the bank originated 90% of the number and 96% of the dollar volume of loans within the defined AA.

LENDING 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.)

Our analysis included a random sample of 46 business loans originated within the bank's AA. As noted above, we selected this loan product for review because it is the bank's primary product line.

The following table displays the bank's lending practices based on our loan sample of business borrowers.

Table 3

| Revenue Distribution-Loans to Businesses Loans Originated in 2003 Sacramento-Arden-Arcade-Roseville MSA | | | | |
|--|--------------|--------------|-------------------------|-------|
| Business Revenues (or Sales) | ≤\$1,000,000 | >\$1,000,000 | Unavailable/ Unknown | Total |
| % of AA Businesses | 63% | 5% | 32% | 100% |
| % of Bank Loans in AA by # | 70% | 30% | 0% | 100% |
| % of Bank Loans in AA by \$ | 57% | 43% | 0% | 100% |

Demographic Data Source: 2003 Dun and Bradstreet Data

Based on our sample, the bank originated a majority of loans by number and a significant number of loans by dollar amount to small businesses. The resulting percentage was 70% and 57%, respectively. The 2003 Business Geodemographic Data showed 63% of reporting businesses having gross annual revenues of \$1 million or less. While the number of loans exceeded the area demographics, the dollar volume closely meets the area demographics.

The following table displays the bank’s lending practices based on our sample of 2004 and 2005 business borrowers.

Table 4

| Revenue Distribution-Loans to Businesses Loans Originated Between 2004 and 2005 Sacramento-Arden-Arcade-Roseville MSA | | | | |
|--|--------------|--------------|-------------------------|-------|
| Business Revenues (or Sales) | ≤\$1,000,000 | >\$1,000,000 | Unavailable/ Unknown | Total |
| % of AA Businesses | 64% | 5% | 31% | 100% |
| % of Bank Loans in AA by # | 65% | 35% | 0% | 100% |
| % of Bank Loans in AA by \$ | 34% | 66% | 0% | 100% |

Demographic Data Source: 2004 Dun and Bradstreet Data

As the table above shows, the percentage of small businesses within the Sacramento-Arden-Arcade-Roseville MSA is 64%. Based on our sample, the bank’s distribution of business loans to businesses with revenues of \$1 million or less exceeded the area demographics by number. The bank originated 65% of the number of loans to small businesses and 34% by dollar volume. The number of loans made to small businesses is an indication that the bank is making more loans to the smallest businesses.

GEOGRAPHIC DISTRIBUTION OF LOANS

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

We reviewed the pattern for geographic distribution of lending in low- and moderate-income tracts within the AA. Dun and Bradstreet demographics track where businesses are located based on U.S. Census information. Table 5 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.

Table 5

| Geographic Distribution of Loans to Businesses Loans Originated Between January 1, 2003 through July 31, 2005 Sacramento-Arden-Arcade-Roseville MSA | | | | | | | | |
|--|--------------------|----------------------|--------------------|----------------------|--------------------|----------------------|--------------------|----------------------|
| Census Tract Income Level | Low | | Moderate | | Middle | | Upper | |
| | % of AA Businesses | % of Number of Loans | % of AA Businesses | % of Number of Loans | % of AA Businesses | % of Number of Loans | % of AA Businesses | % of Number of Loans |
| 2003 Sample ¹ | 10% | 17% | 30% | 49% | 34% | 17% | 26% | 17% |
| 2004 & 2005 Sample ² | 10% | 26% | 30% | 26% | 34% | 18% | 26% | 30% |

Demographic Data Source: ¹ 2003 Dun and Bradstreet, ² 20034 Dun and Bradstreet

Table 5 reflects that in 2003, 17% of the bank’s business borrowers were located in low-income census tracts and 49% were located in moderate-income census tracts. This exceeded the area demographics of 10% and 30%, respectively. For loans that originated between 2004 and 2005, 26% of the bank’s business borrowers were located in low-income census tracts and 26% were located in moderate-income census tracts. While the number of loans made in low-income census tracts exceeded the area demographics of 10%, the number of loans made in moderate-income census tracts was slightly below the area demographics of 26%. This penetration is reasonable in the context of the bank’s size and competition. MNB faces competition with 25 other banks that are larger and have more branches. MNB has only .41% of the market share.

LOAN-TO-DEPOSIT RATIO

The bank's level of lending is not reasonable given the bank's size, area credit needs, and the competitive banking market. However, this is mitigated by the bank’s continued efforts of meeting identified credit needs in low and moderate income areas, through community development loans and lending-related qualified investments.

We analyzed the bank's quarterly LTD ratio from June 2000 through March 2005. During this period, the LTD ranged from a low of 23% to a high of 44%, with an average of 34%. We compared the bank's average ratio to that of three peer banks of comparable asset size that operate in the same assessment area. The peer group's quarterly LTD over the same time period averaged 74%. The bank's average ratio was lower than the peer group average and did not meet the standard for satisfactory performance.

Historically, MNB has maintained very high credit standards, which have resulted in lower than average loan production. The bank has continued with its marketing efforts to increase loan

production. However, when interest rates dropped, MNB lost over \$10 million in its residential mortgage portfolio to its competition offering better rates and terms.

While the bank's loan-to-deposit ratio does not meet the standards for satisfactory performance, MNB has made several community development loans and lending-related qualified investments to meet identified credit needs. For example, MNB has helped revitalize economically depressed areas of its community through its business credit extensions in Enterprise Zones and Redevelopment Areas located in the bank's assessment area. According to bank data, during 2003, 2004, and 2005, the bank extended over \$3.3 million of credit to businesses located in these areas. In addition, MNB extended over \$3.7 million in loans to local community organizations that provided shelter, food, and job training for the homeless and disadvantaged.

In another area of community development, the bank made a lending related qualified investment during this assessment period. MNB purchased \$1.1 million in pass through certificates issued by Fannie Mae, which were backed by residential mortgages. This particular pool of mortgages was comprised of six loans that benefited low- and moderate-income families in the Sacramento Arden-Arcade-Roseville MSA. Fannie Mae is a known provider of financial products and services that make it possible for low- and moderate- income families to buy homes on their own.

Responses to Complaints

No consumer complaints associated with the bank's performance under the provisions of the CRA have been made during the assessment 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.