

PUBLIC DISCLOSURE

July 14, 2003

COMMUNITY REINVESTMENT ACT PERFORMANCE EVALUATION

**Farmers & Merchants State Bank
Certificate Number: 10354**

**01 West Public Square
P.O. Box 188
Ladonia, Texas 75449-0188**

**Division of Supervision and Consumer Protection
Federal Deposit Insurance Corporation
1910 Pacific Avenue, 19th Floor
Dallas, Texas 75201**

NOTE: 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.

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GENERAL INFORMATION

The Community Reinvestment Act (CRA) requires each federal financial supervisory agency to use its authority when examining financial institutions subject to its supervision, to assess the 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. Upon conclusion of such examination, the agency must prepare a written evaluation of the institution's record of meeting the credit needs of its community.

*This document is an evaluation of the Community Reinvestment Act (CRA) performance of **Farmers & Merchants State Bank** prepared by the **Federal Deposit Insurance Corporation**, the institution's supervisory agency, as of **July 14, 2003**. The agency rates the CRA performance of an institution consistent with the provisions set forth in Appendix A to 12 CFR Part 345.*

INSTITUTION RATING

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

Farmers & Merchants State Bank received a “Satisfactory” rating at the previous evaluation dated June 29, 1998.

Small bank performance factors were applied to this two-office, \$16 million bank headquartered in Ladonia, Texas, with a branch office in Honey Grove, Texas. The performance factors are loan-to-deposit (LTD) ratio, lending to borrowers of different incomes and businesses of different sizes, lending in the assessment area, geographic distribution of loans, and response to complaints. No CRA-related complaints have been received since the previous evaluation, so the response to complaints performance factor carried no weight. Investments and services were not reviewed at this evaluation, as requested by the institution.

This evaluation is based upon the bank’s origination of consumer loans. Individual conclusions for each performance factor are summarized below, and details of each performance factor are presented elsewhere in this report.

The institution’s LTD ratio is adequate when compared with peer banks both as of March 31, 2003, and the average LTD since the previous CRA evaluation. The average LTD has increased from 28 percent at the previous evaluation to the present 36 percent average.

The analysis of lending inside and outside the assessment area reflects satisfactory performance. The distribution of consumer lending shows 89 percent by number and 87 percent by dollar volume were originated within the bank’s designated assessment area. The bank’s assessment area consists of only two block numbering areas surrounding their two banking locations, and the high percentage of loans originated within that area indicates that the institution has correctly identified their assessment area.

The analysis of consumer lending within the assessment area meets standards for satisfactory performance regarding lending to borrowers of different incomes. The institution’s lending to low- and moderate-income (LMI) borrowers by number is above the percentage of households within those income categories, which is expected, given the type of loan generally utilized by these borrowers.

The analysis of lending regarding geographic distribution is considered satisfactory. The assessment area is rather homogeneous with one moderate-income BNA, and one middle-income BNA, so less weight is given to this factor. Lending in the moderate-income geography for the consumer loan sample shows 26 percent while the middle-income lending is at 74 percent. The percentage of households in those tract income levels is 27 and 63 percent respectively. These percentages are explainable due to the population located within those BNAs.

DESCRIPTION OF INSTITUTION

Farmer's & Merchants State Bank's main office is located in Ladonia, Texas, with a branch office in Honey Grove, Texas. Both offices are located in Fannin County. Although the charter location is Ladonia, primary operations are conducted out of the Honey Grove location. There is no loan officer in Ladonia, and the only two employees making loans have offices in Honey Grove. Ladonia and Honey Grove are located 130-150 miles northeast of Dallas south of Highway 82. Both communities are rural and Honey Grove has a somewhat active downtown business area with one other banking establishment. The bank's total assets as of March 31, 2003 are reported at \$16,272,000 with total loans at \$4,805,000. Since the previous evaluation dated June 29, 1998, total assets have increased from \$13,152,000, (19 percent), while gross loans have remained constant.

Ownership of the institution has remained with a one-bank holding company with a family distribution of shares, and is unchanged since the previous evaluation. The Fields family owns and operates the bank, established in 1929. There are no ATMs or electronic banking offered; however, there is an informational website for the institution. The bank's lobbies are open from 9:00 a.m. till 2:00 p.m. Monday through Thursday and from 4:00 p.m. to 6:00 p.m. on Friday. The drive-in bank (Honey Grove only) is open until 5:30 p.m. Monday through Thursday and until 6:00 p.m. on Friday. The bank offers all traditional lending products including commercial, agricultural, residential and consumer loans; as well as an array of deposit products.

Table 1 below shows the distribution of the loan portfolio by type of loan as of March 31, 2003.

<i>Table 1 – Loan Distribution as of 03/31/03</i>		
<i>Loan Type</i>	<i>Dollar Amount \$(000s)</i>	<i>Percent of Total Loans (%)</i>
<i>Construction and Land Development</i>	90	1.86
<i>Secured by Farmland</i>	86	1.77
<i>1-4 Family Residential</i>	864	17.81
<i>Multi-Family (5 or more) Residential</i>	0	0
<i>Commercial</i>	201	4.14
<i>Total Real Estate Loans</i>	<i>1,241</i>	<i>25.58</i>
<i>Commercial and Industrial</i>	424	8.75
<i>Agricultural</i>	1,145	23.61
<i>Consumer</i>	1,807	37.26
<i>Other</i>	233	4.8
<i>Total Loans</i>	<i>4,850</i>	<i>100</i>

The institution does not have any financial or legal impediments to prevent it from meeting the credit needs of the assessment area.

DESCRIPTION OF FARMERS AND MERCHANTS STATE BANK ASSESSMENT AREA

Farmers & Merchants State Bank's assessment area consists of two block numbering areas (BNAs) contained in Fannin County, 9501 (middle-income) and 9508 (moderate-income). The assessment area has not changed since the previous evaluation, is reasonably drawn and does not arbitrarily exclude any low- or moderate-income areas which the subject bank would be expected to serve.

The assessment area contained a population of 3,454 as of the 1990 U.S. Census and 1,438 households. The population of Ladonia as of the 2000 Census is reported at 667, while Honey Grove population data shows 1,746. The designated area is primarily rural with small communities interspersed throughout. Communities included in the assessment area are as follows: Dodd City, Windom, Pecan Gap, Telephone, and Wolfe City. Unemployment for Fannin County has increased since 1995 and was 6.9 percent in 2002, compared with the US unemployment rate of 5.8 percent.

A community contact stated that the senior population is around 50 percent with a majority of those on fixed incomes. Assessment area population is shrinking due to the lack of employment opportunities. Area businesses are related to the agricultural industry and thrive or struggle depending on that economy. Housing is limited in the community.

Selected demographics for the assessment area are presented in the following tables based on the 1990 U.S. Census. Housing characteristics are presented in Table 2 and overall demographics and economic data are detailed in Table 3 on the following page.

<i>Table 2 – Selected Housing Characteristics by Income Category of the Geography</i>									
<i>Geographic Income Category</i>	<i>Percentage</i>						<i>Median</i>		
	<i>Census Tracts</i>	<i>House -holds</i>	<i>Housing Units</i>	<i>Owner- Occupied</i>	<i>Rental Units</i>	<i>Vacant Units</i>	<i>Age*</i>	<i>Home Value*</i>	<i>Gross Rent**</i>
<i>Low</i>	0	0	0	0	0	0	0	0	0
<i>Moderate</i>	50	27	26.4	27.6	22.9	26.8	40	22,800	218
<i>Middle</i>	50	63	73.6	72.4	77.1	73.2	28	31,700	259
<i>Upper</i>	0	0	0	0	0	0	0	0	0
<i>Total/Median</i>	<i>100</i>	<i>100</i>	<i>100</i>	<i>100</i>	<i>100</i>	<i>100</i>	<i>31</i>	<i>29,281</i>	<i>250</i>

Source: 1990 U.S. Census, * - Owner-Occupied Units, ** - Renter-Occupied Units

<i>Table 3 – Demographic & Economic Characteristics of the Assessment Area</i>	
<i>Total Population</i>	3,454
<i>Statewide non-MSA Median Family Income:</i>	
<i>1990 Median Family Income</i>	24,585
<i>2001 Estimated Median Family Income (*)</i>	35,800
<i>2002 Estimated Median Family Income(*)</i>	36,100
<i>2003 Estimated Median Family Income (*)</i>	41,200
<i>% of Families by Income Level:</i>	
<i>Low-Income</i>	29.6
<i>Moderate-Income</i>	13.7
<i>Middle-Income</i>	19.0
<i>Upper-Income</i>	37.6
<i>% of Households by Income Level:</i>	
<i>Low-Income</i>	34.4
<i>Moderate-Income</i>	15.0
<i>Middle-Income</i>	14.5
<i>Upper-Income</i>	36.1
<i>Population Information (%):</i>	
<i>Households Below Poverty Level</i>	25.0
<i>Families Below Poverty Level</i>	16.6
<i>Households Receiving Public Assistance</i>	14.3
<i>Persons Over 65 Years of Age</i>	25.8
<i>Number of Total Housing Units:</i>	
<i>1-4 Family Residential</i>	1,746
<i>Multi-Family</i>	65
<i>Mobile Homes or Other</i>	148
<i>Owner-Occupied Housing Units</i>	1,032
<i>Occupied Rental Housing Units</i>	397
<i>Vacant Housing Units</i>	317
<i>% of Total Housing Units:</i>	
<i>1-4 Family Residential</i>	86.5
<i>Multi-Family</i>	3.7
<i>Mobile Homes or Other</i>	8.5
<i>Owner-Occupied Housing Units</i>	59.1
<i>Rental Housing Units</i>	22.7
<i>Vacant Housing Units</i>	18.2

* This figure is based on estimates from the Department of Housing and Urban Development (HUD).

Table 4 on the following page details the income levels based on the HUD estimated median family income figures in Texas non-MSA areas for each year that consumer loans were sampled for this evaluation. This more recent information is used to stratify the loans by borrower income level for statistical evaluations relating to current income demographics, so that comparisons are maintained on a like basis.

Table 4 - Median Family Income Figures for the Texas Non-MSA Geographies					
Income Level	Percent of Median Family Income	Income Range for 1990 (MFI \$24,585)	Income Range for 2001 (MFI \$35,800)	Income Range for 2002 (MFI \$36,100)	Income Range for 2003 (MFI \$41,200)
Low	Less than 50%	Less than \$12,293	Less than \$17,900	Less than \$18,050	Less than \$20,600
Moderate	50% to less than 80%	At least \$12,293, but less than \$19,668	At least \$17,900, but less than \$28,640	At least \$18,050, but less than \$28,880	At least \$20,600, but less than \$32,960
Middle	80% to less than 120%	At least \$19,668, but less than \$29,502	At least \$28,640, but less than \$42,960,	At least \$28,880, but less than \$43,320	At least \$32,960, but less than \$49,440
Upper	120% and over	\$29,502 or greater	\$42,960 or greater	\$43,320 or greater	\$49,440 or greater

Source: HUD Estimated Median Family Incomes for Texas Non-MSA

CONCLUSIONS WITH RESPECT TO PERFORMANCE CRITERIA

Sampling Information

The information contained in Table 5 was provided by the institution regarding lending by loan type for the previous twelve months (June 1, 2002 through May 31, 2003), and included paid out loans for each type.

Table 5 – Loan Origination’s in the Past Twelve Months				
Loan Type	Dollar Amount \$(000s)	Percent (%)	Number of Loans	Percent (%)
Commercial	962	15.39	16	2.94
1-4 Family Residential	354	5.67	13	2.25
Consumer	3,329	53.26	476	82.35
Agricultural	1,606	25.68	72	12.46
Total	6,251	100	578	100

Consumer loans originated in the previous twelve months represented the largest percentage of total loans by number and dollar volume. Consumer loans represent the largest portion of the loan portfolio (as presented in Table 1 above). Agricultural loans represent the second highest percentages by number and dollar volume in the previous twelve months and as a percentage of the loan portfolio; however, on closer review these 72 loans only involved 19 different borrowers. Thus a meaningful statistical sampling of agricultural loans was not possible. Commercial and real estate loans make up such a small percentage of the bank’s portfolio, and of lending in the previous twelve months, an analysis of these loan types would also not be meaningful. Consequently consumer loans were chosen to sample for the evaluation of this bank’s CRA performance.

The analysis for consumer loans began with 304 loans remaining in the bank's portfolio of this type for 2001, 2002, and year-to-date 2003 which totaled \$2,708,016.73. A sample of 45 loans was statistically chosen totaling \$389,534 for analysis of consumer loans.

Loan to Deposit Ratio

The bank's loan-to-deposit (LTD) ratio is adequate when compared to similarly situated banks within the bank's assessment area. As detailed in Table 6 below, as of March 31, 2003, the institution's LTD ratio is lower than one comparable bank and higher than another. The same results are noted for the average LTD ratio since the previous examination. The institution's average LTD has increased from 28 percent to 36 percent since the previous evaluation.

<i>Table 6 – Loan to Deposit Ratio Comparison to Similarly Situated Banks</i>						
<i>Bank Name</i>	<i>City</i>	<i>Total Assets \$(000s)</i>	<i>Net Loans \$(000s)</i>	<i>Total Deposits \$(000s)</i>	<i>Loan-to-Deposit Ratio 03/31/03</i>	<i>Average Loan-to-Deposit Ratio</i>
<i>Farmers & Merchants State Bank</i>	<i>Ladonia</i>	16,272	4,805	14,991	32%	36%
<i>First State Bank</i>	Honey Grove	17,740	4,310	15,766	27%	30%
<i>Fannin Bank</i>	Windom	42,957	28,354	37,277	76%	72%

Source: Consolidated Reports of Condition

Lending Inside the Assessment Area

Analysis of lending inside the assessment area takes into consideration the size of the assessment area in relation to the size and branching structure of the bank. The bank's assessment area reflects the banking locations and the areas where depositors and borrowers live, and is not excessively large for the size of the bank.

The institution's record of lending inside the assessment area meets standards for satisfactory performance. The distribution of consumer lending inside the assessment area totals 89 percent by number and 87 percent by dollar volume. The bank's assessment area consists of only two block numbering areas surrounding their two banking locations, and the high percentage of loans originated within that area indicates that the institution has correctly identified their assessment area. Table 7 below provides details of the above analysis.

<i>Table 7 – Distribution of Consumer Loans Inside and Outside of the Assessment Area</i>	
	<i>Number of Loans</i>
	<i>Dollars in Loans (000s)</i>

	<i>Inside</i>		<i>Outside</i>		<i>Total</i>	<i>Inside</i>		<i>Outside</i>		<i>Total</i>
	<i>#</i>	<i>%</i>	<i>#</i>	<i>%</i>		<i>\$</i>	<i>%</i>	<i>\$</i>	<i>%</i>	
<i>Total</i>	<i>40</i>	<i>89</i>	<i>5</i>	<i>11</i>	<i>45</i>	<i>338,131</i>	<i>87</i>	<i>51,403</i>	<i>13</i>	<i>389,534</i>

Lending to Borrowers of Different Incomes

The analysis of consumer lending within the assessment area revealed satisfactory performance regarding lending to borrowers of different incomes. Lending to low-income borrowers percentage by number exceeded low-income households, as did lending to moderate-income borrowers. This is expected due to the prevalence of consumer lending to these income groups. Lending by dollar volume is lower than the percent of households in both categories, as low- and moderate-income borrowers tend to need loans in smaller amounts.

Consumer loans within the bank's assessment area are analyzed by number and dollar volume comparing these percentages to the percentage of total households at each income level. Table 8 below shows these comparisons.

<i>Table 8 - Distribution of Consumer Loans by Borrower Income</i>					
<i>Median Family Income Level</i>	<i>% Total Households</i>	<i>Consumer Loan Sample 2001, 2002, & YTD 2003</i>		<i>Consumer Loan Sample 2001, 2002, & YTD 2003</i>	
		<i>#</i>	<i>%</i>	<i>\$</i>	<i>%</i>
<i>Low</i>	34.4	19	47.5	69,248	20.5
<i>Moderate</i>	15.0	7	17.5	23,699	7.0
<i>Middle</i>	14.5	5	12.5	90,356	26.7
<i>Upper</i>	36.1	9	22.5	154,828	45.8
<i>Total</i>	<i>100</i>	<i>40</i>	<i>100</i>	<i>338,131</i>	<i>100</i>

Geographic Distribution of Lending

The analysis of lending regarding geographic distribution is considered satisfactory. The assessment area is rather homogeneous with no low-income geographies, one moderate-income geography and one middle-income geography, so less weight is given to this factor. Seventy-four percent of the bank's consumer loans sampled were made in the middle-income geography, around Honey Grove, the larger of the two communities where the bank has a presence. That percentage compares with 63 percent of the households residing in that BNA. Twenty-six percent of the loans were originated in the moderate-income geography surrounding the community of Ladonia, with a population of approximate 650 people as of the 2000 census, where 27 percent of the households reside. Loans were disbursed throughout the bank's

designated assessment area with the majority of the loans originated near bank locations, as expected.

Consumer loans sampled within the bank’s assessment area for 2001, 2002 and year-to-date 2003 are presented in Table 9 on the following page. The percentage of total households by income level of block numbering area from the 1990 US Census is presented for comparison.

<i>Table 9 - Distribution of Consumer Loans by Income Level of Geography</i>					
<i>Median Family Income Level</i>	<i>% Total Households</i>	<i>Consumer Loan Sample 2001, 2002 and YTD 2003</i>		<i>Consumer Loan Sample 2001, 2002, and YTD 2003</i>	
		<i>#</i>	<i>%</i>	<i>\$</i>	<i>%</i>
<i>Low</i>	0	0	0	0	0
<i>Moderate</i>	27	12	30	88,782	26
<i>Middle</i>	63	28	70	249,349	74
<i>Upper</i>	0	0	0	0	0
<i>Total</i>	<i>100</i>	<i>40</i>	<i>100</i>	<i>338,131</i>	<i>100</i>

Response to Complaints

No CRA related complaints were filed with the FDIC since the previous evaluation and the bank had no record of any other complaints. This factor was not considered in determining the overall performance rating. Communication between senior management and compliance personnel indicates that complaints would receive adequate attention, should they be received.

Compliance with Anti-Discrimination Laws and Regulations

No violations of the substantive provisions of the anti-discriminatory laws and regulations were identified during this examination.

GLOSSARY

GEOGRAPHY TERMS:

Assessment Area - a geographic area delineated by the bank in accordance with the requirements of the Community Reinvestment Act.

Block Numbering Area [BNA] - an area defined by the U.S. Census Bureau with State assistance, similar to a census tract, usually located in rural areas.

Census Tracts: Small subdivisions of metropolitan and other densely populated counties. Census tract boundaries do not cross county lines; however, they may cross the boundaries of metropolitan statistical areas. They usually have between 2,500 and 8,000 persons, and their physical size varies widely depending upon population density. Census tracts are designed to be homogeneous with respect to population characteristics, economic status, and living conditions to allow for statistical comparisons.

Geography - a census tract or block numbering area delineated by the U.S. Census Bureau in the most recent decennial census.

Non-Metropolitan Area - All areas outside of metropolitan statistical areas. The definition of non-metropolitan is not consistent with the definition of rural areas. Urban and rural classifications cut across the other hierarchies; for example, there is generally both urban and rural territory within both metropolitan and non-metropolitan areas.

INCOME TERMS:

Median Family Income: Family income derived from the 2000 U.S. Census data and adjusted by the Department of Housing and Urban Development (HUD) annually for metropolitan and non-metropolitan areas. HUD starts with the most recent U.S. Census data and factors in information from other sources to arrive an annual estimate that more closely reflects current economic conditions. Half of the family incomes are estimated below and half are estimated above this figure.

Low-Income - Individual income that is less than 50 percent of the area median income, or a median family income that is less than 50 percent in the case of a geography.

- For a block numbering area - this income range is less than 50 percent of the MFI for all non-MSA areas in the state in which the block numbering area is located.

- For individuals - this refers to income levels less than 50 percent of the most recent year's estimation of the MFI by the Department of Housing and Urban Development [HUD].

Moderate-income: Individual income that is at least 50 percent and less than 80 percent of the area median income, or a median family income that is at least 50 percent and less than 80 percent in the case of a geography.

Middle-income: Individual income that is at least 80 percent and less than 120 percent of the area median income, or a median family income that is at least 80 percent and less than 120 percent in the case of a geography

Upper-income: Individual income that is more than 120 percent of the area median income, or a median family income that is more than 120 percent in the case of a geography.

OTHER TERMS:

Family: includes a householder and one or more other person living in the same household who is related to the householder by birth, marriage, or adoption. The number of family households always equals the number of families; however, a family household may also include non-relatives living with the family. Families are not classified into "male householder" (a family with a male householder and no wife present) or "female householder" (a family with a female householder and no husband present).

Household: A household consists of all the people who occupy a housing unit. A house, an apartment or other group of rooms, or a single room, is regarded as a housing unit when it is occupied or intended for occupancy as separate living quarters; that is, when the occupants do not live and eat with any other persons in the structure and there is direct access from the outside or through a common hall. A household includes the related family members and all the unrelated people, if any, such as lodgers, foster children, wards, or employees who share the housing unit. A person living alone in a housing unit, or a group of unrelated people sharing a housing unit such as partners or roomers, is also counted as a household. The count of households excludes group quarters. There are two major categories of households, "family" and "non-family".