SIERRA BANCORP
Form 10-K
March 14, 2013

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, 2012**

**Commission file number: 000-33063**

**SIERRA BANCORP**

(Exact name of registrant as specified in its charter)

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| **California** | **33-0937517** |
| (State of incorporation) | (I.R.S. Employer Identification No.) |

| | |
|---|---|
| **86 North Main Street, Porterville, California** | **93257** |
| (Address of principal executive offices) | (Zip Code) |

**(559) 782-4900**

Registrant's telephone number, including area code

**Securities registered pursuant to Section 12(b) of the Act:**

| Title of each class | Name of each exchange on which registered |
|---|---|
| **Common Stock, No Par Value** | **The NASDAQ Stock Market LLC (NASDAQ Global Select Market)** |

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

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

¨ Yes þ 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 þ 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.

þ Yes ¨ No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

þ 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, or a smaller reporting company.

| | |
|---|---|
| Large accelerated filer ¨ | Accelerated filer þ |
| Non-accelerated filer ¨ (Do not check if a smaller reporting company) | Smaller reporting company ¨ |

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act).

¨ Yes þ No

As of June 30, 2012, the last business day of the registrant's most recently completed second fiscal quarter, the aggregate market value of the voting stock held by non-affiliates of the registrant was approximately $106 million, based on the closing price reported to the registrant on that date of $9.90 per share. Shares of Common Stock held by each officer and director and each person or control group owning more than ten percent of the outstanding Common Stock have been excluded in that such persons may be deemed to be affiliates. This determination of affiliate status is not necessarily a conclusive determination for other purposes.

The number of shares of common stock of the registrant outstanding as of February 28, 2013 was 14,114,879.

Documents Incorporated by Reference: Portions of the definitive proxy statement for the 2013 Annual Meeting of Shareholders to be filed with the Securities and Exchange Commission pursuant to SEC Regulation 14A are incorporated by reference in Part III, Items 10-14.

**TABLE OF CONTENTS**

**PART I**

**Item 1. Business**

**General**

**The Company**

Sierra Bancorp (the "Company") is a California corporation headquartered in Porterville, California, and is a registered bank holding company under federal banking laws. The Company was formed to serve as the holding company for Bank of the Sierra (the "Bank"), and has been the Bank's sole shareholder since August 2001. The Company exists primarily for the purpose of holding the stock of the Bank and of such other subsidiaries it may acquire or establish. At the present time, the Company's only other direct subsidiaries are Sierra Statutory Trust II and Sierra Capital Trust III, which were formed in March 2004 and June 2006, respectively, solely to facilitate the issuance of capital trust pass-through securities (TRUPS). Pursuant to the Financial Accounting Standards Board's (FASB's) standard on the consolidation of variable interest entities, these trusts are not reflected on a consolidated basis in the financial statements of the Company. References herein to the "Company" include Sierra Bancorp and its consolidated subsidiary, the Bank, unless the context indicates otherwise.

At December 31, 2012, the Company had consolidated assets of $1.438 billion, gross loans of $880 million, deposits of $1.174 billion and shareholders' equity of $174 million. The Company's liabilities include $31 million in debt obligations due to Sierra Statutory Trust II and Sierra Capital Trust III, related to TRUPS issued by those entities.

**The Bank**

The Bank is a California state-chartered bank headquartered in Porterville, California, that offers a full range of retail and commercial banking services to communities in the central and southern sections of the San Joaquin Valley. Our branch footprint stretches from Fresno on the north to Bakersfield on the south, and on the southern end extends east through the Tehachapi plateau and into the northwestern tip of the Mojave Desert. The Bank was incorporated in September 1977 and opened for business in January 1978, and in the ensuing years has grown to be the largest independent bank headquartered in the South San Joaquin Valley. Our growth has primarily been organic, but includes the acquisition of Sierra National Bank in 2000.

Our chief products and services are related to the business of lending money and accepting deposits. The Bank's lending activities include real estate, commercial (including small business), agricultural, and consumer loans. The bulk of our real estate loans are secured by commercial or professional office properties which are predominantly owner-occupied. We also employ real estate lending specialists who are responsible for a complete line of construction loans for residential and commercial development, permanent mortgage loans, land acquisition and development loans, and multifamily credit facilities. Secondary market services are provided through the Bank's affiliations with Freddie Mac, Fannie Mae and various non-governmental programs. As of December 31, 2012, the percentage of our total loan and lease portfolio for each of the principal areas in which we direct our lending activities was as follows: (i) loans secured by real estate (62.0%); (ii) commercial and industrial loans (including SBA loans) (31.6%); (iii) consumer loans (3.3%); (iv) direct finance leases (0.5%); and (v) agricultural production loans (2.6%). Real estate loans and related activities generated total revenue of $33.2 million in 2012 and $36.1 million in 2011. Interest, fees, and loan sale income on real-estate secured loans totaled approximately 48% of our net interest plus other income for 2012 and 53% in 2011.

In addition to loans, we offer a wide range of deposit products for individuals and businesses including checking accounts, savings accounts, money market demand accounts, time deposits, retirement accounts, and sweep accounts. The Bank's deposit accounts are insured by the Federal Deposit Insurance Corporation (FDIC) up to maximum insurable amounts. We have also been in the Certificate of Deposit Account Registry Service (CDARS) network since its inception, and through CDARS are able to offer full FDIC insurance coverage on multi-million dollar deposits up to specified limits. We attract deposits from throughout our market area with direct-mail campaigns, a customer-oriented product mix, competitive pricing, convenient locations, drive-through banking, and a multitude of alternative delivery channels, and we strive to retain our deposit customers by providing a consistently high level of service. At December 31, 2012 we had 92,700 deposit accounts totaling $1.174 billion, compared to 90,400 deposit accounts totaling $1.086 billion at December 31, 2011.

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We currently operate 25 full service branch offices throughout our geographic footprint. Our most recent branch changes include the third-quarter 2012 relocation of the Bank's Clovis branch to a larger facility in a more convenient location, and the first-quarter 2011 opening of a new branch in the City of Selma. The locations of the Bank's current offices are:

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| Porterville: | Administrative Headquarters<br>86 North Main Street | Main Office<br>90 North Main Street | West Olive Branch<br>1498 West Olive Avenue |
| Bakersfield: | Bakersfield Ming Office<br>8500 Ming Avenue | Bakersfield Riverlakes Office<br>4060 Coffee Road | Bakersfield East Hills Office<br>2501 Mt. Vernon Avenue |
| California City: | California City Office<br>8031 California City Blvd. | | |
| Clovis: | Clovis Office<br>1835 East Shaw Avenue | | |
| Delano: | Delano Office<br>1126 Main Street | | |
| Dinuba: | Dinuba Office<br>401 East Tulare Street | | |
| Exeter: | Exeter Office<br>1103 West Visalia Road | | |
| Farmersville: | Farmersville Office<br>400 West Visalia Road | | |
| Fresno: | Fresno Shaw Office<br>636 East Shaw Avenue | Fresno Herndon Office<br>7029 N. Ingram Avenue | Fresno Sunnyside Office<br>5775 E. Kings Canyon Rd. |
| Hanford: | Hanford Office<br>427 West Lacey Boulevard | | |
| Lindsay: | Lindsay Office<br>142 South Mirage Avenue | | |
| Reedley: | Reedley Office<br>1095 W. Manning Street | | |
| Selma: | Selma Office<br>2446 McCall Avenue | | |
| Tehachapi: | Tehachapi Downtown Office<br>224 West "F" Street | Tehachapi Old Town Office<br>21000 Mission Street | |

| | | |
|---|---|---|
| Three Rivers: | Three Rivers Office<br>40884 Sierra Drive | |
| Tulare: | Tulare Office<br>246 East Tulare Avenue | Tulare Prosperity Office<br>1430 E Prosperity Avenue |
| Visalia: | Visalia Mooney Office<br>2515 South Mooney Blvd. | Visalia Downtown Office<br>128 East Main Street |

In addition to the full-service branch offices listed above the Bank has a real estate industries group, an agricultural credit division, and an SBA lending unit. We also have ATM's at all branch locations, and offsite ATM's at six different non-branch locations. Furthermore, the Bank is a member of the Allpoint network, which provides our customers with surcharge-free access to over 38,000 ATM's across the nation and another 12,000 ATM's in foreign countries, and our customers have access to electronic point-of-sale payment alternatives nationwide via the Pulse EFT network. To ensure that account access preferences are addressed for all of our customers, we operate an internet branch which provides the ability to open deposit accounts and submit certain loan applications online, offer an online banking option with bill-pay and mobile banking capabilities, maintain a customer service center that is accessible by toll-free telephone during business hours, and provide an automated telephone banking system that is accessible 24 hours a day, seven days a week. We offer a multitude of other banking products and services to complement and support our lending and deposit products, including remote deposit capture and automated payroll services for business customers. To provide non-deposit investment options we have a strategic alliance with Investment Centers of America, Inc. of Bismarck, North Dakota ("ICA"). Through this arrangement, registered and licensed representatives of ICA provide our customers with convenient access to annuities, insurance products, mutual funds, and a full range of investment products.

We have not engaged in any material research activities related to the development of new products or services during the last two fiscal years. However, our officers and employees are continually searching for ways to increase public convenience, enhance public access to the electronic payments system, and enable us to improve our competitive position. The cost to the Bank for these development, operations, and marketing activities cannot be calculated with any degree of certainty.

We hold no patents or licenses (other than licenses required by appropriate bank regulatory agencies), franchises, or concessions. Our business has a modest seasonal component due to the heavy agricultural orientation of the Central Valley, but as our branches in more metropolitan areas have expanded we have become less reliant on the agriculture-related base. We are not dependent on a single customer or group of related customers for a material portion of our core deposits, nor is a material portion of our loans concentrated within a single industry or group of related industries. Our efforts to comply with government and regulatory mandates on consumer protection and privacy, anti-terrorism, and other initiatives have resulted in significant ongoing expense to the Bank, including staffing additions and costs associated with compliance-related software. However, as far as can be determined there has been no material effect upon our capital expenditures, earnings, or competitive position as a result of environmental regulation at the Federal, state, or local level.

**Recent Accounting Pronouncements**

Information on recent accounting pronouncements is contained in Note 2 to the consolidated financial statements.

**Competition**

The banking business in California in general, and specifically in many of our market areas, is highly competitive with respect to virtually all products and services. The industry continues to consolidate, particularly with the relatively large number of FDIC-assisted takeovers of failed banks and other acquisitions of troubled banks in recent years. There are also many unregulated companies competing for business in our markets with financial products targeted at highly profitable customer segments. Many of these competitors are able to compete across geographic boundaries, and provide customers with meaningful alternatives to nearly all significant banking services and products. These competitive trends are likely to continue.

With respect to commercial bank competitors, the business is dominated by a relatively small number of major banks that operate a large number of offices within our geographic footprint. Based on June 30, 2012 FDIC market share data for the combined four counties within which the Company operates, namely Tulare, Kern, Fresno, and Kings counties, the largest portion of deposits belongs to Wells Fargo Bank (21.7%), followed by Bank of America (17.1%). The next three institutions are multi-billion dollar institutions which have market share percentages between 6% and 7%. Bank of the Sierra ranks sixth on the 2012 market share list, with 5.4% of total deposits in the referenced four-county area. In Tulare County, however, where the Bank was originally formed, we rank first for deposit market share with 19.4% of total deposits, and have the largest number of branch locations (12, including our online branch). The larger banks noted above have, among other advantages, the ability to finance wide-ranging advertising campaigns and to allocate their resources to regions of highest yield and demand. They can also offer certain services that we do not offer directly but may offer indirectly through correspondent institutions. By virtue of their greater total capitalization, these banks also have substantially higher lending limits than we do. For customers whose needs exceed our legal lending limits, we typically arrange for the sale, or “participation,” of some of the balances to financial institutions that are not within our geographic footprint.

In addition to other banks, our competitors include savings institutions, credit unions, and numerous non-banking institutions such as finance companies, leasing companies, insurance companies, brokerage firms, asset management groups, mortgage banking firms and internet-based companies. Technological innovations have lowered traditional barriers of entry and enabled many of these companies to offer services that previously were considered traditional banking products, and we have witnessed increased competition from companies that circumvent the banking system by facilitating payments via the internet, wireless devices, prepaid cards, and other means.

Strong competition for deposits and loans among financial institutions and non-banks alike affects interest rates and other terms on which financial products are offered to customers. Mergers between financial institutions have created additional pressures within the industry to remain competitive by streamlining operations, reducing expenses, and increasing revenues. Competition is also impacted by federal and state interstate banking laws enacted in the mid-1990's, which permit banking organizations to expand into other states. The relatively large California market has been particularly attractive to out-of-state institutions. Competitive conditions were further intensified in the year 2000 by the enactment of the Financial Modernization Act, which made it possible for full affiliations to occur between banks and securities firms, insurance companies, and other financial companies.

For years we have countered rising competition by offering a broad array of products with flexibility in structure and terms that cannot always be matched by our competitors. We also offer our customers community-oriented, personalized service, and rely on local promotional activity and personal contacts by our officers, directors, employees, and shareholders. This approach appears to be well-received by the populace of the San Joaquin Valley, who appreciate a high-touch, customer-oriented environment in which to conduct their financial transactions. As noted above, layered onto our traditional personal-contact banking philosophy are technology-driven initiatives that improve customer access and convenience.

**Employees**

As of December 31, 2012 the Company had 328 full-time and 90 part-time employees. On a full-time equivalent basis staffing stood at 399 at December 31, 2012, up from 383 at December 31, 2011 due primarily to the addition of staff for lending activities.

**Regulation and Supervision**

Banks and bank holding companies are heavily regulated by federal and state laws and regulations. Most banking regulations are intended primarily for the protection of depositors and the deposit insurance fund and not for the benefit of shareholders. The following is a summary of certain statutes, regulations and regulatory guidance affecting the Company and the Bank. This summary is not intended to be a complete explanation of such statutes, regulations and guidance, all of which are subject to change in the future, nor does it fully address their effects and potential effects on the Company and the Bank.

**Regulation of the Company Generally**

The Company's stock is traded on the NASDAQ Global Select Market under the symbol BSRR, and as such the Company is subject to NASDAQ rules and regulations including those related to corporate governance. The Company is also subject to the periodic reporting requirements of Section 13 of the Securities Exchange Act of 1934 (the "Exchange Act") which requires the Company to file annual, quarterly and other current reports with the Securities and Exchange Commission (the "SEC"). The Company is subject to additional regulations including, but not limited to, the proxy and tender offer rules promulgated by the SEC under Sections 13 and 14 of the Exchange Act; the reporting requirements of directors, executive officers and principal shareholders regarding transactions in the Company's common stock, and short swing profits rules promulgated by the SEC, under Section 16 of the Exchange Act; and certain additional reporting requirements for principal shareholders of the Company promulgated by the SEC under Section 13 of the Exchange Act. As a publicly traded company which had more than $75 million in public float as of June 30, 2012, the Company is classified as an "accelerated filer" for purposes of its Exchange Act filing requirements. In addition to accelerated time frames for filing SEC periodic reports, this also means that the Company is subject to the requirements of Section 404 of the Sarbanes-Oxley Act of 2002 with regard to documenting, testing, and attesting to internal controls over financial reporting.

The Company is a bank holding company within the meaning of the Bank Holding Company Act of 1956 and is registered as such with the Federal Reserve Board. A bank holding company is required to file with the Federal Reserve annual reports and other information regarding its business operations and those of its subsidiaries. It is also subject to periodic examination by the Federal Reserve and is required to obtain Federal Reserve approval before acquiring, directly or indirectly, ownership of the voting shares of any bank if, after such acquisition, it would directly or indirectly own or control more than 5% of the voting stock of that bank, unless it already owns a majority of the voting stock of that bank.

The Federal Reserve Board has determined by regulation certain activities in which a bank holding company may or may not conduct business. A bank holding company must engage, with certain exceptions, in the business of banking or managing or controlling banks or furnishing services to or performing services for its subsidiary banks. The principal exceptions to those prohibitions involve non-bank activities identified by statute, by Federal Reserve regulation, or by Federal Reserve order as activities so closely related to the business of banking or of managing or controlling banks as to be a proper incident thereto, including securities brokerage services, investment advisory services, fiduciary services, and management advisory and data processing services, among others. A bank holding company that also qualifies as and elects to become a "financial holding company" may engage in a broader range of activities that are financial in nature (and complementary to such activities), specifically non-bank activities identified by the Gramm-Leach-Bliley Act of 1999 or by Federal Reserve and Treasury regulation as financial in nature or incidental to a financial activity. Activities that are defined as financial in nature include securities underwriting, dealing, and market making, sponsoring mutual funds and investment companies, engaging in insurance underwriting and agency activities, and making merchant banking investments in non-financial companies. To become and remain a financial holding company, a bank holding company and its subsidiary banks must be well capitalized, well managed, and, except in limited circumstances, have at least a satisfactory rating under the Community Reinvestment Act. The Company has no current intention of becoming a financial holding company, but may do so at some point in the future if deemed appropriate in view of opportunities or circumstances at the time.

The Company and the Bank are deemed to be affiliates of each other within the meaning set forth in the Federal Reserve Act and are subject to Sections 23A and 23B of the Federal Reserve Act. The Federal Reserve Board has also issued Regulation W, which codifies prior regulations under Sections 23A and 23B of the Federal Reserve Act and related interpretative guidance with respect to affiliate transactions. This means, for example, that there are limitations on loans by the Bank to affiliates, and that all affiliate transactions must satisfy certain limitations and otherwise be on terms and conditions at least as favorable to the Bank as would be available for non-affiliates. In addition, we must comply with the Federal Reserve Act and Regulation O issued by the Federal Reserve Board, which require that loans and extensions of credit to our executive officers, directors and principal shareholders, or any company controlled by any such persons, shall, among other conditions, be made on substantially the same terms and follow credit-underwriting procedures no less stringent than those prevailing at the time for comparable transactions with non-insiders.

Regulations and policies of the Federal Reserve Board require a bank holding company to serve as a source of financial and managerial strength to its subsidiary banks. It is the Federal Reserve Board's policy that a bank holding company should stand ready to use available resources to provide adequate capital funds to a subsidiary bank during periods of financial stress or adversity and should maintain the financial flexibility and capital-raising capacity to obtain additional resources for assisting a subsidiary bank. Under certain conditions, the Federal Reserve Board may conclude that certain actions of a bank holding company, such as a payment of a cash dividend, would constitute an unsafe and unsound banking practice. The Federal Reserve Board also has the authority to regulate the debt of bank holding companies, including the authority to impose interest rate ceilings and reserve requirements on such debt. Under certain circumstances, the Federal Reserve Board may require a bank holding company to file written notice and obtain its approval prior to purchasing or redeeming its equity securities, unless certain conditions are met.

**Regulation of the Bank Generally**

As a California state-chartered bank whose accounts are insured by the FDIC up to the maximum limits allowable by law, the Bank is subject to regulation, supervision and regular examination by the California Department of Financial Institutions (the "DFI") and the FDIC. In addition, while the Bank is not a member of the Federal Reserve System, the Bank is subject to certain regulations of the Federal Reserve Board. The regulations of these agencies govern most aspects of the Bank's business, including the making of periodic reports by the Bank, and the Bank's activities relating to dividends, investments, loans, borrowings, capital requirements, certain check-clearing activities, branching, mergers and acquisitions, reserves against deposits and numerous other areas. Supervision, legal action and examination by the FDIC are generally intended to protect depositors and are not intended for the protection of shareholders.

The earnings and growth of the Bank are largely dependent on our ability to maintain a favorable differential, or "spread," between our yield on interest-earning assets and the average rate paid on our deposits and other interest-bearing liabilities. As a result, the Bank's performance is influenced by general economic conditions, both domestic and foreign, the monetary and fiscal policies of the federal government, and the policies of the regulatory agencies, particularly the Federal Reserve Board. The Federal Reserve Board implements national monetary policies (such as, for example, seeking to curb inflation and combat recession) by its open-market operations in United States government securities, by adjusting the required level of reserves for financial institutions subject to its reserve requirements, by varying the discount rate applicable to borrowings by banks that participate in the Federal Reserve System, and through quantitative easing. The actions of the Federal Reserve Board in those areas influence the growth of bank loans, investments and deposits and also affect interest rates on loans and deposits. The nature and impact of any future changes in monetary policies cannot be predicted with any degree of certainty.

**Capital Adequacy Requirements**

The Company and the Bank are subject to the regulations of the Federal Reserve Board and the FDIC, respectively, governing capital adequacy. Each of the federal regulators has established risk-based and leverage capital guidelines for the banks and/or bank holding companies it regulates, which set total capital requirements and define capital in terms of "core capital elements," or Tier 1 capital; and "supplemental capital elements," or Tier 2 capital. Tier 1 capital is generally defined as the sum of the core capital elements less goodwill and certain other deductions, including the unrealized net gains or losses (after tax adjustments) on available-for-sale investment securities, and disallowed deferred tax assets. The following items are defined as core capital elements: (i) common shareholders' equity; (ii) qualifying non-cumulative perpetual preferred stock and related surplus (and, in the case of holding companies, senior perpetual preferred stock issued to the U.S. Treasury Department pursuant to the Troubled Asset Relief Program); (iii) minority interests in the equity accounts of consolidated subsidiaries; and (iv) "restricted" core capital elements (which include qualifying trust preferred securities) up to 25% of all core capital elements, net of goodwill less any associated deferred tax liability. As of December 31, 2012, TRUPS comprised approximately 16% of the Company's Tier 1 capital. Supplementary capital elements include: (i) allowance for loan and lease losses (but not more than 1.25% of an institution's risk-weighted assets); (ii) perpetual preferred stock and related surplus not qualifying as core capital;

(iii) hybrid capital instruments, perpetual debt and mandatory convertible debt instruments; and, (iv) term subordinated debt and intermediate-term preferred stock and related surplus. The maximum amount of Tier 2 capital is capped at 100% of Tier 1 capital.

The minimum required ratio of qualifying total capital to total risk-weighted assets is 8% ("Total Risk-Based Capital Ratio"), and the minimum required ratio of Tier 1 capital to total risk-weighted assets is 4% ("Tier 1 Risk-Based Capital Ratio"). Risk-based capital ratios are calculated to provide a measure of capital relative to the degree of risk associated with a financial institution's operations for transactions reported on the balance sheet as assets, and transactions, such as letters of credit and recourse arrangements, which are recorded as off-balance sheet items. Under risk-based capital guidelines, the nominal dollar amounts of assets and credit-equivalent amounts of off-balance sheet items are multiplied by one of several risk adjustment percentages, which range from 0% for assets with low credit risk, such as cash on hand and certain U.S. Treasury securities, to 100% for assets with relatively high credit risk, such as unsecured loans. As of December 31, 2012 and 2011, Bank-only Total Risk-Based Capital Ratios were 19.14% and 20.89%, respectively, and the Bank's Tier 1 Risk-Based Capital Ratios were 17.88% and 19.63%, respectively. As of December 31, 2012 and 2011, the consolidated Company's Total Risk-Based Capital Ratios were 19.36% and 21.72%, respectively, and its Tier 1 Risk-Based Capital Ratios were 18.11% and 20.46%, respectively.

The FDIC and the Federal Reserve Board have also established guidelines for a financial institution's leverage ratio, defined as Tier 1 capital to adjusted total assets. Banks and bank holding companies that have received the highest rating of the five categories used by regulators to rate banks and are not anticipating or experiencing any significant growth must maintain a leverage ratio of at least 3%. All other institutions are typically required to maintain a leverage ratio of at least 4% to 5%; however, federal regulations also provide that financial institutions must maintain capital levels commensurate with the level of risk to which they are exposed, including the volume and severity of problem loans, and federal regulators may set higher capital requirements when an institution's particular circumstances warrant. Bank-only leverage ratios were 13.17% and 13.53% on December 31, 2012 and 2011, respectively. As of December 31, 2012 and 2011, the consolidated Company's leverage ratios were 13.34% and 14.11%, respectively.

Risk-based capital requirements also take into account concentrations of credit involving collateral or loan type, and the risks of "non-traditional" activities (those that have not customarily been part of the banking business). The regulations require institutions with high or inordinate levels of risk to operate with higher minimum capital standards, and authorize the regulators to review an institution's management of such risks in assessing an institution's capital adequacy. Additionally, the regulatory Statements of Policy on risk-based capital include exposure to interest rate risk as a factor that the regulators will consider in evaluating a financial institution's capital adequacy, although interest rate risk does not impact the calculation of an institution's risk-based capital ratios. Interest rate risk is the exposure of a bank's current and future earnings and equity capital to adverse movement in interest rates. While interest rate risk is inherent in a financial institution's role as a financial intermediary, it introduces volatility to the institution's earnings and economic value.

As noted above, under the current rules of the Federal Reserve Board qualified trust preferred securities are one of several "restricted" core capital elements which may be included in Tier 1 capital, subject to certain limitations. Amounts of restricted core capital elements in excess of established limits generally may be included in Tier 2 capital. Since the Company had less than $15 billion in assets at December 31, 2012, under the Dodd-Frank Act the Company will be able to continue to include its existing trust preferred securities in Tier 1 Capital to the extent permitted by FRB guidelines. However, as discussed in the next paragraph, the treatment of the Company's trust preferred securities will change in the future if currently proposed regulations are adopted.

On June 12, 2012, banking regulators issued a notice of proposed rulemaking outlining potential new regulatory capital guidelines which conform to Basel III requirements. While there is lingering uncertainty with regard to exemptions that might apply to community banks, if ultimately adopted as proposed the new rules would, among other things:

1) add a new regulatory capital component referred to as "Common Equity Tier 1 capital", and establish threshold ratios for this new component (e.g., 6.5% to be "well-capitalized");
2) impose a new "capital conservation buffer" of at least 2.5% of risk-weighted assets to be added to Common Equity Tier 1 capital, and limit dividend payments, share buybacks, and certain discretionary bonus payments to executive officers if the capital conservation buffer is not achieved;

3) provide a phase-out period for the inclusion of TRUPS as Tier 1 capital (although TRUPS would likely still be includible in Tier 2 capital);

4) require us to include accumulated other comprehensive income (AOCI) in Tier 1 capital, which could significantly increase capital volatility;

5) impose additional constraints on the inclusion of minority interests, mortgage servicing assets, and deferred tax assets in regulatory capital;

6) adjust risk-weightings for certain assets, including the assignment of a risk weighting of 150% to certain acquisition/development and construction loans, a risk weighting of 150% for loans that are more than 90-days past due or are on non-accrual status, and risk weightings for residential mortgages based on loan-to-value ratios and certain other loan characteristics; and

7) increase minimum required ratios over a phase-in period, and increase the threshold for a “well-capitalized” classification for the Tier 1 Risk-Based Capital Ratio from 6% to 8%.

The largest impact on the consolidated Company would likely come from the exclusion of $30 million in TRUPS from Tier 1 capital. Other potential changes that could materially affect us include the additional constraints on the inclusion of deferred tax assets in capital, increased risk weightings for nonperforming loans and acquisition/development loans, and the inclusion of accumulated other comprehensive income in regulatory capital. The inclusion of AOCI would benefit us as long as we have a net unrealized gain on securities, but would lower our regulatory capital ratios if interest rates increase and our unrealized gain becomes an unrealized loss.

The aggregate effect of these regulatory changes on Sierra Bancorp and Bank of the Sierra cannot yet be determined with any degree of certainty, but our preliminary estimates indicate that if the changes are implemented and when they become fully phased-in they could have a material impact on our Tier 1 Leverage Ratio and our consolidated Tier 1 Risk-Based Capital Ratio. Nevertheless, given our current level of capital we should be well-positioned to absorb the impact of Basel III without constraining our organic growth plans, although no assurance can be provided in that regard.

For more information on the Company's capital, see Part II, Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operation – Capital Resources. Risk-based capital ratio requirements are discussed in greater detail in the following section.

**Prompt Corrective Action Provisions**

Federal law requires each federal banking agency to take prompt corrective action to resolve the problems of insured financial institutions, including but not limited to those that fall below one or more prescribed minimum capital ratios. The federal banking agencies have by regulation defined the following five capital categories: "well capitalized" (Total Risk-Based Capital Ratio of 10%; Tier 1 Risk-Based Capital Ratio of 6%; and Leverage Ratio of 5%); "adequately capitalized" (Total Risk-Based Capital Ratio of 8%; Tier 1 Risk-Based Capital Ratio of 4%; and Leverage Ratio of 4%, or 3% if the institution receives the highest rating from its primary regulator); "undercapitalized" (Total Risk-Based Capital Ratio of less than 8%; Tier 1 Risk-Based Capital Ratio of less than 4%; or Leverage Ratio of less than 4%, or 3% if the institution receives the highest rating from its primary regulator); "significantly undercapitalized" (Total Risk-Based Capital Ratio of less than 6%; Tier 1 Risk-Based Capital Ratio of less than 3%; or Leverage Ratio less than 3%); and "critically undercapitalized" (tangible equity to total assets less than 2%). A bank may be treated as though it were in the next lower capital category if, after notice and the opportunity for a hearing, the appropriate federal agency finds an unsafe or unsound condition or practice so warrants, but no bank may be treated as "critically undercapitalized" unless its actual capital ratio warrants such treatment. As of December 31, 2012 and 2011, both the Company and the Bank were deemed to be well capitalized for regulatory capital purposes.

At each successively lower capital category, an insured bank is subject to increased restrictions on its operations. For example, a bank is generally prohibited from paying management fees to any controlling persons or from making capital distributions if to do so would make the bank "undercapitalized." Asset growth and branching restrictions apply to undercapitalized banks, which are required to submit written capital restoration plans meeting specified requirements (including a guarantee by the parent holding company, if any). “Significantly undercapitalized” banks are subject to broad regulatory authority, including among other things, capital directives, forced mergers, restrictions on the rates of interest they may pay on deposits, restrictions on asset growth and activities, and prohibitions on paying bonuses or increasing compensation to senior executive officers without FDIC approval. Even more severe restrictions apply to “critically undercapitalized” banks. Most importantly, except under limited circumstances, not later than 90 days after an insured bank becomes critically undercapitalized the appropriate federal banking agency is required to appoint a conservator or receiver for the bank.

In addition to measures taken under the prompt corrective action provisions, insured banks may be subject to potential actions by the federal regulators for unsafe or unsound practices in conducting their businesses or for violations of any law, rule, regulation or any condition imposed in writing by the agency or any written agreement with the agency. Enforcement actions may include the issuance of cease and desist orders, termination of insurance of deposits (in the case of a bank), the imposition of civil money penalties, the issuance of directives to increase capital, formal and informal agreements, or removal and prohibition orders against “institution-affiliated” parties.

**Safety and Soundness Standards**

The federal banking agencies have also adopted guidelines establishing safety and soundness standards for all insured depository institutions. Those guidelines relate to internal controls, information systems, internal audit systems, loan underwriting and documentation, compensation and interest rate exposure. In general, the standards are designed to assist the federal banking agencies in identifying and addressing problems at insured depository institutions before capital becomes impaired. If an institution fails to meet the requisite standards, the appropriate federal banking agency may require the institution to submit a compliance plan and could institute enforcement proceedings if an acceptable compliance plan is not submitted or adhered to.

**The Dodd-Frank Wall Street Reform and Consumer Protection Act**

The Dodd-Frank Wall Street Reform and Consumer Protection Act financial reform legislation (“Dodd-Frank”) significantly revised and expanded the rulemaking, supervisory, and enforcement authority of the federal bank regulatory agencies. Dodd-Frank impacts many aspects of the financial industry and, in many cases, will impact larger and smaller financial institutions and community banks differently over time. Many of the following key provisions of Dodd-Frank are already effective or are in the proposed rule or implementation stage:

- a change to permanent status for the previously-implemented temporary increase in FDIC deposit insurance to $250,000, and an extension of federal deposit insurance coverage through December 31, 2012 for the full net amount held by depositors in non-interesting bearing transaction accounts;
- authorization for financial institutions to pay interest on business checking accounts, as a result of which the Company began to pay interested on a limited number of business checking accounts in August, 2011;
- changes in the calculation of FDIC deposit insurance assessments, such that the assessment base is no longer an institution’s deposit base but instead is the institution’s average consolidated total assets less its average tangible equity, as a result of which smaller banks are now paying proportionately less and larger banks proportionately more of the aggregate insurance assessments;
- the requirement that interchange fees by debit card issuers be reasonable and proportional to the cost incurred, which does not apply directly to banks with less than $10 billion in assets but nonetheless affects smaller banks due to competitive factors;
- the creation of a Consumer Financial Protection Bureau within the Federal Reserve (discussed below) with centralized responsibility for consumer protection;
- provisions that affect corporate governance and executive compensation at most publicly-traded companies in the United States, including proxy access requirements for shareholders, non-binding shareholder votes on executive compensation, the establishment of an independent compensation committee, enhanced executive compensation disclosures and compensation claw-backs;
- the application of the same leverage and risk-based capital requirements that apply to insured depository institutions to most bank holding companies, and the elimination and phase-out of trust preferred securities from Tier 1 capital with certain exceptions (which exceptions currently enable the Company to continue to include trust preferred securities as Tier 1 capital);
- codification of the requirement that bank holding companies serve as a source of financial strength for their depository institution subsidiaries;

- expansion of restrictions on transactions with affiliates and insiders under Section 23A and 23B of the Federal Reserve Act, and lending limits for derivative transactions, repurchase agreements, and securities lending and borrowing transactions;
- the elimination of remaining barriers to de novo interstate branching by banks; and
- enhanced regulation of financial markets, including the derivative and securitization markets, and the elimination of certain proprietary trading activities by banks ( the “Volcker Rule”).

Dodd-Frank also contains a number of provisions which should not directly impact the Company, such as the prohibition against charter conversions for troubled institutions; the elimination of the Office of Thrift Supervision, and the transfer of oversight responsibilities for thrift institutions and their holding companies to the Office of the Comptroller of the Currency or to the FDIC and the Federal Reserve; the termination of investments by the U.S. Treasury under the Troubled Asset Relief Program; the creation of a Financial Services Oversight Counsel to identify emerging systemic risks and improve interagency cooperation; and the establishment of enhanced standards for risk-based capital, leverage limits, stress testing, liquidity, risk management, and concentration/credit exposure limits for institutions with total consolidated assets of $50 billion or more. However, some of those provisions could have an indirect impact on the Company due to their influence on the industry generally.

Because many of the regulations related to Dodd-Frank have not yet been issued or fully implemented, the statute's ultimate effect on the financial services industry in general, and on the Company in particular, is uncertain at this time. However, it is expected that certain provisions of Dodd-Frank may significantly impact our operations and expenses, including, for example, changes in FDIC assessments, the permitted payment of interest on demand deposits, and enhanced compliance requirements. Some of the rules and regulations promulgated or yet to be promulgated under Dodd-Frank will apply directly to institutions much larger than ours, but could indirectly impact smaller banks, either due to competitive influences or because certain required practices for larger institutions may subsequently become expected "best practices" for smaller institutions. We expect that we may need to devote even more management attention and resources to evaluate and make any changes necessary to comply with new statutory and regulatory requirements under Dodd-Frank.

**Deposit Insurance**

The Bank's deposits are insured under the Federal Deposit Insurance Act, up to the maximum applicable limits by the Deposit Insurance Fund ("DIF") of the FDIC and are subject to deposit insurance assessments to maintain the DIF. In October 2010, the FDIC adopted a revised restoration plan to ensure that the DIF's designated reserve ratio ("DRR") reaches 1.35% of insured deposits by September 30, 2020, the deadline mandated by the Dodd-Frank Act. However, financial institutions like Bank of the Sierra with assets of less than $10 billion are exempted from the cost of this increase. Furthermore, the restoration plan proposed an increase in the DRR to 2% of estimated insured deposits as a long-term goal for the fund. The FDIC also proposed future assessment rate reductions in lieu of dividends, when the DRR reaches 1.5% or greater.

As noted above, the Dodd-Frank Act provided for a permanent increase in FDIC deposit insurance per depositor from $100,000 to $250,000 retroactive to January 1, 2008, and extended unlimited deposit insurance coverage for non-interest bearing transaction accounts through December 31, 2012. Furthermore, the FDIC redefined its deposit insurance premium assessment base from an institution's total domestic deposits to its total assets less tangible equity, effective in the second quarter of 2011. The changes to the assessment base necessitated changes to assessment rates, which also became effective April 1, 2011. The revised assessment rates are lower than prior rates, but the assessment base is larger and approximately the same amount of assessment revenue is being collected by the FDIC.

To help address liquidity issues created by potential timing differences between the collection of premiums and charges against the DIF, in November 2009 the FDIC adopted a final rule to require insured institutions to prepay, on December 31, 2009, estimated quarterly risk-based deposit insurance assessments for the fourth quarter of 2009, and for all of 2010, 2011 and 2012. Because our actual payments from 2010 through 2012 were lower than the original estimate, the Bank had $1.7 million of the prepaid regulatory assessment remaining on its books as of December 31, 2012. Until such time as our prepaid FDIC assessment is fully utilized, our accounting offset for FDIC assessment expense is the prepaid account rather than cash.

We are generally unable to control the amount of premiums that we are required to pay for FDIC insurance. If there are additional bank or financial institution failures or if the FDIC otherwise determines, we may be required to pay even higher FDIC premiums than the recent levels. Any future increases in FDIC insurance premiums may have a material adverse effect on our earnings and could have a material adverse effect on the value of, or market for, our common stock.

In addition to DIF assessments, banks must pay quarterly assessments that are applied to the retirement of Financing Corporation bonds issued in the 1980's to assist in the recovery of the savings and loan industry. The assessment amount fluctuates, but was 0.66 basis points of insured deposits for the fourth quarter of 2012. Those assessments will continue until the Financing Corporation bonds mature in 2019.

10

**Community Reinvestment Act**

The Bank is subject to certain requirements and reporting obligations involving Community Reinvestment Act ("CRA") activities. The CRA generally requires federal banking agencies to evaluate the record of a financial institution in meeting the credit needs of its local communities, including low and moderate income neighborhoods. The CRA further requires the agencies to consider a financial institution's efforts in meeting its community credit needs when evaluating applications for, among other things, domestic branches, mergers or acquisitions, or the formation of holding companies. In measuring a bank's compliance with its CRA obligations, the regulators utilize a performance-based evaluation system under which CRA ratings are determined by the bank's actual lending, service, and investment performance, rather than on the extent to which the institution conducts needs assessments, documents community outreach activities or complies with other procedural requirements. In connection with its assessment of CRA performance, the FDIC assigns a rating of "outstanding," "satisfactory," "needs to improve" or "substantial noncompliance." The Bank's most recent rating is a "satisfactory" CRA assessment rating, assigned in July 2011.

**Privacy and Data Security**

The Gramm-Leach-Bliley Act, also known as the Financial Modernization Act of 1999 (the "Financial Modernization Act"), imposed requirements on financial institutions with respect to consumer privacy. Financial institutions, however, are required to comply with state law if it is more protective of consumer privacy than the Financial Modernization Act. The Financial Modernization Act generally prohibits disclosure of consumer information to non-affiliated third parties unless the consumer has been given the opportunity to object and has not objected to such disclosure. The statute also directed federal regulators, including the Federal Reserve and the FDIC, to establish standards for the security of consumer information, and requires financial institutions to disclose their privacy policies to consumers annually.

**Overdrafts**

The Electronic Funds Transfer Act, as implemented by the Federal Reserve's Regulation E (which was updated effective January 2010 with a mandatory compliance date of July 1, 2010), governs transfers initiated through automated teller machines (ATMs), point-of-sale terminals, and other electronic banking services. Regulation E prohibits financial institutions from assessing an overdraft fee for paying ATM and one-time point-of-sale debit card transactions, unless the customer affirmatively opts in to the overdraft service for those types of transactions. The opt-in provision establishes requirements for clear disclosure of fees and terms of overdraft services for ATM and one-time debit card transactions. The rule does not apply to other types of transactions, such as check, automated clearinghouse (ACH) and recurring debit card transactions.

Additionally, in November 2010, the FDIC issued its Overdraft Guidance on automated overdraft service programs to ensure that a bank mitigates the risks associated with offering automated overdraft payment programs and complies with all consumer protection laws and regulations. The procedural changes and fee adjustments necessitated by those regulatory changes resulted in decreased overdraft income for the Company in 2011 and 2012, and could have a further adverse impact on non-interest income in the future.

**Predatory Lending**

The term “predatory lending” is far-reaching and covers a potentially broad range of behavior. As such, it does not lend itself to a concise or comprehensive definition. Typically, predatory lending involves at least one, and perhaps all three, of the following elements: making unaffordable loans based on a borrower’s assets rather than on the borrower’s ability to repay an obligation, or asset-based lending; inducing a borrower to refinance a loan repeatedly in order to charge high points and fees each time the loan is refinanced, or loan flipping; and engaging in fraud or deception to conceal the true nature of the loan obligation from an unsuspecting or unsophisticated borrower.

Federal Reserve Board regulations aimed at curbing such lending significantly widened the pool of high-cost home-secured loans covered by the Home Ownership and Equity Protection Act of 1994, a federal law that requires extra disclosures and consumer protections to borrowers. In addition, the regulation bars loan flipping by the same lender or loan servicer within a year. Lenders also will be presumed to have violated the law which says loans shouldn’t be made to people unable to repay them, unless they document that the borrower has the ability to repay. Lenders that violate the rules face cancellation of loans and penalties equal to the finance charges paid. The Company does not engage in predatory lending, and thus does not expect these rules or potential future regulations in this area to have any impact on its financial condition or results of operations.

**Consumer Financial Protection and Other Consumer Laws and Regulations**

Dodd-Frank created the Consumer Financial Protection Bureau (CFPB) as a new and independent unit within the Federal Reserve System. With certain exceptions, the CFPB has authority to regulate any person or entity that engages in offering or providing a "consumer financial product or service," and it has rulemaking, examination, and enforcement powers over financial institutions. With respect to primary examination and enforcement authority of financial entities, however, the CFPB's authority is limited to institutions with assets of $10 billion or more. Existing regulators retain this authority over institutions with assets of $10 billion or less, such as the Bank.

The powers of the CFPB currently include:

- the ability to prescribe consumer financial laws and rules that regulate all institutions that engage in offering or providing a consumer financial product or service;
- primary enforcement and exclusive supervision authority over insured institutions with assets of $10 billion or more with respect to federal consumer financial laws, including the right to obtain information about an institution's activities and compliance systems and procedures and to detect and assess risks to consumers and markets;
- the ability to require reports from institutions with assets under $10 billion to support the CFPB in implementing federal consumer financial laws, supporting examination activities, and assessing and detecting risks to consumers and financial markets; and
- examination authority (limited to assessing compliance with federal consumer financial law) with respect to institutions with assets under $10 billion, such as the Bank, to the extent that a CFPB examiner may be included in the examinations performed by the institution's primary regulator.

The CFPB officially commenced operations on July 21, 2011 and has engaged in numerous activities since then, including (i) investigating consumer complaints about credit cards and mortgages, (ii) launching a supervision program, (iii) conducting research for and developing mandatory financial product disclosures, and (iv) engaging in consumer financial protection rulemaking.

Some uncertainty has arisen related to confidential treatment and privilege and the CFPB's ability to require reports from financial institutions. Banks currently have express legal protection that gives them the confidence and legal certainty to provide confidential "privileged" documents at the request of the federal banking agencies, and the current law provides that a bank does not "waive" confidentiality and risk disclosure of the information to an outside party, potentially involved in litigation with the bank, by providing the information to its regulator. The CFPB does not have the same express statutory protections relating to privilege that the other banking agencies are given. The full extent of the CFPB's authority and potential impact on the Bank is unclear at this time, and the Bank continues to monitor the CFPB's activities on an ongoing basis.

The Bank is already subject to a variety of statutes and regulations designed to protect consumers, including the Fair Credit Reporting Act, Equal Credit Opportunity Act, and Truth-in-Lending Act. Interest and other charges collected or contracted for by the Bank are also subject to state usury laws and certain other federal laws concerning interest rates. The Bank's loan operations are also subject to federal laws and regulations applicable to credit transactions. Together, these laws and regulations include provisions that:

- govern disclosures of credit terms to borrowers who are consumers;
- require financial institutions to provide information to enable the public and public officials to determine whether a financial institution is fulfilling its obligations in meeting the housing needs of the communities it serves;
- prohibit discrimination on the basis of race, creed, or other prohibited factors in extending credit;
- govern the use and provision of information to credit reporting agencies; and
- govern the manner in which consumer debts may be collected by collection agencies.

The Bank’s deposit operations are also subject to laws and regulations that:

- impose a duty to maintain the confidentiality of consumer financial records and prescribe procedures for complying with administrative subpoenas of financial records; and
- govern automatic deposits to and withdrawals from deposit accounts and customers’ rights and liabilities arising from the use of automated teller machines and other electronic banking services.

**The Emergency Economic Stabilization Act of 2008 and the Troubled Asset Relief Program**

In response to the market turmoil and financial crises affecting the overall banking system and financial markets in the United States, the Emergency Economic Stabilization Act of 2008 (EESA) was enacted in October 2008. In February 2009, the American Recovery and Reinvestment Act of 2009 (the “Stimulus Bill”) was enacted, which among other things augmented certain provisions of the EESA. Under the EESA, the Treasury Department has authority to purchase up to $700 billion in mortgage loans, mortgage-related securities and certain other financial instruments, including debt and equity securities issued by financial institutions in the Troubled Asset Relief Program (the “TARP”). The purpose of the TARP was to restore confidence and stability to the U.S. banking system and to encourage financial institutions to increase lending to customers and to each other.

The Treasury Department allocated $250 billion in TARP-authorized funds to the TARP Capital Purchase Program, which was developed to purchase senior preferred stock from qualifying financial institutions in order to strengthen their capital and liquidity positions and encourage them to increase lending to creditworthy borrowers. Qualifying financial institutions could be approved to issue preferred stock to the Treasury Department in amounts not less than 1% of their risk-weighted assets and not more than the lesser of $25 billion or 3% of risk-weighted assets. After evaluating the strategic advantages and operating restrictions inherent in issuing preferred shares to the U.S. government, Sierra Bancorp elected not to participate in the capital purchase element of TARP.

The EESA also established a Temporary Liquidity Guarantee Program (TLGP) that gave the FDIC the ability to provide a guarantee for newly-issued senior unsecured debt and non-interest bearing transaction deposit accounts at eligible insured institutions. The transaction account guarantee program was initially scheduled to continue through December 31, 2010, but the Dodd-Frank Act extended full deposit insurance coverage for non-interest bearing transaction accounts through December 31, 2012, and all financial institutions were required to participate.

**Interstate Banking and Branching**

The Riegle Neal Interstate Banking and Branching Efficiency Act of 1994 (the “Interstate Banking Act”) regulates the interstate activities of banks and bank holding companies and establishes a framework for nationwide interstate banking and branching. Since 1995, adequately capitalized and managed bank holding companies have been permitted to acquire banks located in any state, subject to two exceptions: first, any state may still prohibit bank holding companies from acquiring a bank which is less than five years old; and second, no interstate acquisition can be consummated by a bank holding company if the acquirer would control more than 10% of the deposits held by insured depository institutions nationwide or 30% or more of the deposits held by insured depository institutions in any state in which the target bank has branches. In 1995, California enacted legislation to implement important provisions of the Interstate Banking Act and to repeal California's previous interstate banking laws, which were largely preempted by the Interstate Banking Act. A bank may establish and operate de novo branches in any state in which the bank does not maintain a branch if that state has enacted legislation to expressly permit all out-of-state banks to establish branches in that state. However, California law expressly prohibits an out-of-state bank which does not already have a California branch office from (i) purchasing a branch office of a California bank (as opposed to purchasing the entire bank) and thereby establishing a California branch office, or (ii) establishing a de novo branch in California. It appears that the Interstate Banking Act and related California laws have contributed to the accelerated consolidation of the banking industry and increased competition, with many large out-of-state banks having entered the California market as a result of this legislation.

USA Patriot Act of 2001

The impact of the USA Patriot Act of 2001 (the "Patriot Act") on financial institutions of all kinds has been significant and wide ranging. The Patriot Act substantially enhanced existing anti-money laundering and financial transparency laws, and required appropriate regulatory authorities to adopt rules that promote cooperation among financial institutions, regulators, and law enforcement entities in identifying parties that may be involved in terrorism or money laundering. Under the Patriot Act, financial institutions are subject to prohibitions regarding specified financial transactions and account relationships, as well as enhanced due diligence and "know your customer" standards in their dealings with foreign financial institutions and foreign customers. The Patriot Act also requires all financial institutions to establish anti-money laundering programs. The Bank expanded its Bank Secrecy Act compliance staff and intensified due diligence procedures concerning the opening of new accounts to fulfill the anti-money laundering requirements of the Patriot Act, and also implemented systems and procedures to identify suspicious banking activity and report any such activity to the Financial Crimes Enforcement Network.

**Sarbanes-Oxley Act of 2002**

The Company is subject to the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley) which addresses, among other issues, corporate governance, auditing and accounting, executive compensation, and enhanced and timely disclosure of corporate information. Among other things, Sarbanes-Oxley mandates chief executive and chief financial officer certifications of periodic financial reports, additional financial disclosures concerning off-balance sheet items, and accelerated share transaction reporting for executive officers, directors and 10% shareholders. In addition, Sarbanes-Oxley increased penalties for non-compliance with the Exchange Act. SEC rules promulgated pursuant to Sarbanes-Oxley impose obligations and restrictions on auditors and audit committees intended to enhance their independence from management, and include extensive additional disclosure, corporate governance and other related rules.

**Commercial Real Estate Lending Concentrations**

In December 2006, the federal bank regulatory agencies released Guidance on Concentrations in Commercial Real Estate (CRE) Lending, Sound Risk Management Practices (the "Guidance"). The Guidance, which was issued in response to the agencies' concern that rising CRE concentrations might expose institutions to unanticipated earnings and capital volatility in the event of adverse changes in the commercial real estate market, reinforced existing regulations and guidelines for real estate lending and loan portfolio management. Highlights of the Guidance include the following:

- The Guidance reminds institutions that strong risk management practices and appropriate levels of capital are important elements of a sound CRE lending program.
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The Guidance applies to national banks and state chartered banks, and is also broadly applicable to bank holding companies. For purposes of the Guidance, CRE loans include loans for land development and construction, other land loans, and loans secured by multifamily and nonfarm residential properties. The definition also extends to loans to real estate investment trusts and unsecured loans to developers if their performance is closely linked to the performance of the general CRE market.

- The agencies recognize that banks serve a vital role in their communities by supplying credit for business and real estate development, therefore the Guidance is not intended to limit banks' CRE lending. Instead, the Guidance encourages institutions to identify and monitor credit concentrations, establish internal concentration limits, and report concentrations to management and the board of directors on a periodic basis.
- The agencies recognize that different types of CRE lending present different levels of risk, and therefore, institutions are encouraged to segment their CRE portfolios to acknowledge these distinctions. However, the CRE portfolio should not be divided into multiple sections simply to avoid the appearance of risk concentration.
- Institutions should address the following key elements in establishing a risk management framework for identifying, monitoring, and controlling CRE risk: (1) board of directors and management oversight; (2) portfolio management; (3) management information systems; (4) market analysis; (5) credit underwriting standards; (6) portfolio stress testing and sensitivity analysis; and (7) credit review function.
- As part of the ongoing supervisory monitoring processes, the agencies use certain criteria to identify institutions that are potentially exposed to significant CRE concentration risk. An institution that has experienced rapid growth in CRE lending, has notable exposure to a specific type of CRE, or is approaching or exceeds specified supervisory criteria, may be identified for further supervisory analysis.

14

The Bank believes that the Guidance is applicable to it, as it has a relatively high level concentration in CRE loans. The Bank and its board of directors have discussed the Guidance and believe that the Bank's underwriting policies, management information systems, independent credit administration process, and monitoring of real estate loan concentrations are sufficient to address the Guidance.

**Allowance for Loan and Lease Losses**

In December 2006, the federal bank regulatory agencies released an Interagency Policy Statement on the Allowance for Loan and Lease Losses (ALLL), which revises and replaces the banking agencies' 1993 policy statement on the ALLL. The revised statement was issued to ensure consistency with generally accepted accounting principles (GAAP) and more recent supervisory guidance, and it extended the scope to include credit unions. Highlights of the revised statement include the following:

- the revised statement emphasizes that the ALLL represents one of the most significant estimates in an institution's financial statements and regulatory reports, and that an assessment of the appropriateness of the ALLL is critical to an institution's safety and soundness;
- each institution has a responsibility to develop, maintain, and document a comprehensive, systematic, and consistently applied process for determining the amounts of the ALLL;
- each institution must maintain an ALLL that is sufficient to cover estimated credit losses on individual impaired loans as well as estimated credit losses inherent in the remainder of the portfolio; and
- the revised statement clarifies previous guidance on the ALLL with regard to: (1) responsibilities of the board of directors, management, and bank examiners; (2) factors to be considered in the estimation of ALLL; and (3) objectives and elements of an effective loan review system.

In December 2012, the FASB issued a proposed accounting standards update on "Financial Instruments–Credit Losses" with the goal of eliminating the overstatement of assets caused by a delayed recognition of credit losses associated with loans (and other financial instruments). Comments on the proposal are due by April 30, 2013, but no effective date for the guidance has been suggested. If ultimately implemented as proposed, the guidance would require us to modify the methodology we use to determine our allowance for loan and lease losses from the current "incurred loss" model to a new "expected credit loss" model that considers more forward-looking information. That change could potentially necessitate a significant increase in our allowance for loan and lease losses, which could negatively impact our profitability if our loan loss provision needs to be increased accordingly.

**Other Pending and Proposed Legislation**

Other legislative and regulatory initiatives which could affect the Company, the Bank and the banking industry in general are pending, and additional initiatives may be proposed or introduced before the United States Congress, the California legislature and other governmental bodies in the future. Such proposals, if enacted, may further alter the structure, regulation and competitive relationship among financial institutions, and may subject the Bank to increased regulation, disclosure and reporting requirements. In addition, the various banking regulatory agencies often adopt new rules and regulations to implement and enforce existing legislation. It cannot be predicted whether, or in what form, any such legislation or regulations may be enacted or the extent to which the business of the Company or the Bank would be affected thereby.

**Item 1A. RISK FACTORS**

You should carefully consider the following risk factors and all other information contained in this Annual Report before making investment decisions concerning the Company's common stock. The risks and uncertainties described below are not the only ones the Company faces. Additional risks and uncertainties not presently known to the Company or that the Company currently believes are immaterial may also adversely impact the Company's business. If any of the events described in the following risk factors occur, the Company's business, results of operations and financial condition could be materially adversely affected. In addition, the trading price of the Company's common stock could decline due to any of the events described in these risks.

Risks Relating to the Bank and to the Business of Banking in General

**Our business has been and may continue to be adversely affected by volatile conditions in the financial markets and unfavorable economic conditions generally.** From December 2007 through June 2009, the U.S. economy was officially in recession. Business activity across a wide range of industries and regions in the U.S. was greatly reduced during that time frame, and remains at subdued or recessionary levels in many parts of the Country today. The financial markets and the financial services industry in particular have suffered unprecedented disruption, causing a number of institutions to fail or to require government intervention to avoid failure.

As a result of adverse financial and economic conditions, many lending institutions, including our company, experienced significant declines in the performance of their loans, particularly construction, development and land loans, and unsecured commercial and consumer loans. Our nonperforming assets have been at elevated levels since the beginning of the recession in 2007, and totaled $72.8 million, or 8.10% of total loans and foreclosed assets at December 31, 2012, relative to only $689,000, or 0.08% of total loans and foreclosed assets at the end of 2006.

The California economy has been particularly hard hit, and the economic decline has been a major factor in the significant increase in the Company's nonperforming assets and loan charge-offs since mid-2007. Unemployment levels have always been relatively high in the San Joaquin Valley and in Tulare County, which is our geographic center and the base of our agriculturally oriented communities, but recessionary conditions pushed the unemployment rate to exceptionally high levels in recent years. The unemployment rate for Tulare County reached a high of 19.2% during the current economic cycle, in March 2010. It was 15.7% for December 2012, down slightly from 16.5% in December 2011 and 17.9% in December 2010, but still well above the 9.7% aggregate unemployment rate for California in December 2012.

Although there are indications of improving economic conditions nationally, certain sectors, such as real estate, remain relatively weak and unemployment remains high in many of our local markets. The state government, most local governments, and many local businesses are still experiencing difficulties due to relatively low consumer and business confidence, reduced consumer spending, and a drop in tax revenues. In addition, the values of the real estate collateral supporting many commercial loans and home mortgages have declined and could decline further. Any new negative market developments could further adversely affect consumer confidence levels and payment patterns, which could cause delinquencies and default rates to remain at high levels.

If business and economic conditions do not improve generally or in the principal markets in which we do business, the prolonged economic weakness could have one or more of the following adverse effects on our business:

- a lack of demand for loans, or other products and services offered by us;
- a continued decline in the value of our loans or other assets secured by residential or commercial real estate;
- a decrease in deposit balances due to increased pressure on the liquidity of our customers;

- an impairment of our investment securities; or
- an increase in the number of borrowers who become delinquent, file for protection under bankruptcy laws or default on their loans or other obligations to us, which in turn could result in a higher level of nonperforming assets, net charge-offs and provision for credit losses.

**Challenges in the agricultural industry could have an adverse effect on our customers and their ability to make payments to us.** While the Company’s current relatively high level of nonperforming assets is comprised mainly of other real estate owned and loans secured by land, lots, and commercial/residential real estate, the drivers behind high levels of nonperforming assets in previous economic cycles include difficulties experienced by the agricultural industry in our market areas. This is due to the fact that a considerable portion of our borrowers are involved in, or are impacted to some extent by, the agricultural industry. While a great number of our borrowers are not directly involved in agriculture, they would likely be impacted by difficulties in the agricultural industry since many jobs in the San Joaquin Valley are ancillary to the regular production, processing, marketing and sales of agricultural commodities.

The markets for agricultural products can be adversely impacted by increased supply from overseas competition, a drop in consumer demand, and numerous other factors. The ripple effect of any resulting drop in commodity prices could lower borrower income and depress collateral values. Weather patterns are also of critical importance to row crop, tree fruit, and citrus production. A degenerative cycle of weather has the potential to adversely affect agricultural industries as well as consumer purchasing power, and could lead to further unemployment throughout the San Joaquin Valley. Another potential looming issue that could have a major impact on the agricultural industry involves water distribution rights. If the amount of water available to agriculture becomes increasingly scarce due to drought and/or diversion to other uses, farmers may not be able to continue to produce agricultural products at a reasonable profit, which has the potential to force many out of business. Such conditions have affected and may continue to adversely affect our borrowers and, by extension, our business, and if general agricultural conditions decline our level of nonperforming assets could increase.

**Concentrations of real estate loans could subject us to increased risks in the event of a prolonged real estate recession or natural disaster.** Our loan portfolio is heavily concentrated in real estate loans, particularly commercial real estate. At December 31, 2012, 62% of our loan portfolio consisted of real estate loans, and a sizeable portion of the remaining loan portfolio has real estate collateral as a secondary source of repayment or as an abundance of caution. Balances secured by commercial buildings and construction and development loans represented 56% of all real estate loans, while loans secured by residential properties accounted for 31%, and loans secured by farmland were 13% of real estate loans. The Company’s $72.8 million balance of nonperforming assets at December 31, 2012 includes nonperforming real estate loans totaling $46.6 million, and $19.8 million in foreclosed assets comprised primarily of other real estate owned (OREO).

The Central Valley residential real estate market experienced significant deflation in property values during 2008 and 2009, with little change from recessionary lows since then, and foreclosures have occurred at relatively high rates since the beginning of the recession. If residential real estate values in our market areas slide further, and/or if this weakness further impacts commercial real estate values, the Company could experience additional migration into nonperforming assets. An increase in nonperforming assets could have a material adverse effect on our financial condition and results of operations by reducing our income and increasing our expenses. Continued deterioration in real estate values might also further reduce the amount of loans the Company makes to businesses in the construction and real estate industry, which could negatively impact our organic growth prospects. Similarly, the occurrence of a natural disaster like those California has experienced in the past, including earthquakes, brush fires, and flooding, could impair the value of the collateral we hold for real estate secured loans and negatively impact our results of operations.

In addition, banking regulators now give commercial real estate loans extremely close scrutiny due to risks relating to the cyclical nature of the real estate market, and related risks for lenders with high concentrations of such loans. The regulators have required banks with relatively high levels of CRE loans to implement enhanced underwriting standards, internal controls, risk management policies and portfolio stress testing, which has resulted in higher allowances for possible loan losses. Expectations for higher capital levels have also materialized. Any increase in our allowance for loan losses would adversely affect our net income, and any requirement that we maintain higher capital levels could adversely impact financial performance measures such as earnings per share.

**Our concentrations of commercial real estate, construction and land development, and commercial and industrial loans expose us to increased lending risks.** Commercial real estate, construction and land development, and commercial and industrial loans and leases, including agricultural production loans but not including SBA-guaranteed loans, comprised approximately 67% of our total loan portfolio as of December 31, 2012, and expose the Company to a greater risk of loss than residential real estate and consumer loans, which comprised a smaller percentage of the total loan portfolio. Commercial real estate and land development loans typically involve larger loan balances to single borrowers or groups of related borrowers compared to residential loans. Consequently, an adverse development with respect to one commercial loan or one credit relationship exposes us to a greater risk of loss compared to an adverse development with respect to one residential mortgage loan.

**Repayment of our commercial loans is often dependent on the cash flows of the borrower, which may be unpredictable, and the collateral securing these loans may fluctuate in value.** At December 31, 2012, we had $285 million or 32% of total loans in commercial loans and leases, including agricultural production loans but not including SBA-guaranteed loans. Commercial lending involves risks that are different from those associated with residential and commercial real estate lending. Real estate lending is generally considered to be collateral based lending with loan amounts based on predetermined loan to collateral values and liquidation of the underlying real estate collateral being viewed as the primary source of repayment in the event of borrower default. Our commercial loans are primarily made based on the cash flows of the borrowers and secondarily on any underlying collateral provided by the borrowers. A borrower's cash flows may be unpredictable, and collateral securing those loans may fluctuate in value. Although commercial loans are often collateralized by equipment, inventory, accounts receivable, or other business assets, the liquidation of collateral in the event of default is often an insufficient source of repayment because accounts receivable may be uncollectible and inventories may be obsolete or of limited use, among other things.

**Nonperforming assets adversely affect our results of operations and financial condition, and can take significant time to resolve.** Until economic and market conditions improve, we expect that our nonperforming loans will continue at relatively high levels, which will continue to negatively impact earnings and could have a substantial adverse impact if conditions deteriorate further. We do not record interest income on non-accrual loans, thereby adversely affecting our level of interest income. Furthermore, when we receive collateral through foreclosures and similar proceedings, we are required to record the collateral at its fair market value less estimated selling costs, which may result in write-downs or losses. Additionally, our non-interest expense has increased due to the costs of reappraising adversely classified assets, write-downs on foreclosed assets subsequent to reappraisals reflecting lower values, operating costs related to foreclosed assets, legal and other costs associated with loan collections, and various other expenses that would not typically be incurred in a more normal operating environment. An increase in the level of nonperforming assets also increases our risk profile and may impact the capital levels our regulators believe is appropriate in light of such risks. We utilize various techniques such as loan sales, workouts and restructurings to manage our problem assets. Deterioration in the value of these problem assets, the underlying collateral, or in the borrowers' performance or financial condition, could adversely affect our business, results of operations and financial condition. In addition, the resolution of nonperforming assets requires a significant commitment of time from management and staff, which can be detrimental to their performance of other responsibilities. There can be no assurance that we will avoid further increases in nonperforming loans in the future.

**We may experience loan and lease losses in excess of our allowance for such losses.** We endeavor to limit the risk that borrowers might fail to repay; nevertheless, losses can and do occur. We maintain an allowance for estimated loan and lease losses in our accounting records, based on estimates of:

- historical experience with our loans;
- evaluation of economic conditions;
- regular reviews of the quality, mix and size of the overall loan portfolio;
- a detailed cash flow analysis for nonperforming loans;
- regular reviews of delinquencies; and
- the quality of the collateral underlying our loans.

We maintain our allowance for loan and lease losses at a level that we believe is adequate to absorb specifically identified probable losses as well as any other losses inherent in our loan portfolio at a given date. While we strive to carefully monitor credit quality and to identify loans that may become nonperforming, at any given time there are loans in the portfolio that could result in losses but that have not been identified as nonperforming or potential problem loans. We cannot be sure that we will be able to identify deteriorating loans before they become nonperforming assets, or that we will be able to limit losses on those loans that have been so identified. Changes in economic, operating and other conditions which are beyond our control, including interest rate fluctuations, deteriorating values in underlying collateral (most of which consists of real estate), and changes in the financial condition of borrowers, may cause our estimate of probable losses or actual loan losses to exceed our current allowance. In addition, the FDIC and the DFI, as part of their supervisory functions, periodically review our allowance for loan and lease losses. Such agencies may require us to increase our provision for loan and lease losses or to recognize further losses based on their judgment, which may be different from that of our management. Any such increase in the allowance required by the FDIC or the DFI could also hurt our business.

**Our use of appraisals in deciding whether to make a loan on or secured by real property does not ensure the value of the collateral.** In considering whether to make a loan secured by real property, we generally require an appraisal of the property. However, an appraisal is only an estimate of the value of the property at the time the appraisal is made, and an error in fact or judgment could adversely affect the reliability of an appraisal. In addition, events occurring after the initial appraisal may cause the value of the real estate to decrease. As a result of any of these factors the value of collateral backing a loan may be less than supposed, and if a default occurs we may not recover the entire outstanding balance of the loan.

**Our expenses could increase as a result of increases in FDIC insurance premiums.** The FDIC, absent extraordinary circumstances, must establish and implement a plan to restore the deposit insurance reserve ratio to 1.35% of estimated insured deposits or the comparable percentage of the assessment base at any time the reserve ratio falls below that level. Bank failures during the current economic cycle depleted the deposit insurance fund balance, which was in a negative position from the end of 2009 through the first quarter of 2011. The balance had increased to $25.2 billion with a resulting reserve ratio of 0.35% as of September 30, 2012. The FDIC currently has until September 30, 2020 to bring the reserve ratio back to the statutory minimum. As noted above under “Regulation and Supervision – Deposit Insurance”, the FDIC has implemented a restoration plan that adopted a new assessment base and established new assessment rates starting with the second quarter of 2011. The FDIC also imposed a special assessment in 2009, and required the prepayment of three years of estimated FDIC insurance premiums at the end of 2009. It is generally expected that assessment rates will remain relatively high in the near term due to the significant cost of bank failures and the relatively large number of troubled banks. Any further premium increases or special assessments could have a material adverse effect on our financial condition and results of operations.

**We may not be able to continue to attract and retain banking customers, and our efforts to compete may reduce our profitability.** The banking business in our current and intended future market areas is highly competitive with respect to virtually all products and services, and that competition may limit our ability to attract and retain banking customers. In California generally, and in our service areas specifically, branches of major banks dominate the commercial banking industry. Such banks have substantially greater lending limits than we have, offer certain services we cannot offer directly, and often operate with economies of scale that result in relatively low operating costs on a per loan or per asset basis. We also compete with numerous financial and quasi-financial institutions for deposits and loans, including providers of financial services over the internet. New technology and other changes are allowing parties to effectuate financial transactions that previously required the involvement of banks. For example, consumers can maintain funds in brokerage accounts or mutual funds that would have historically been held as bank deposits. Consumers can also complete transactions such as paying bills and 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 access to lower cost deposits as a source of funds could have a material adverse effect on our financial condition and results of operations.

In addition, with the large number of bank failures in the past few years, customers have been more concerned about the extent to which their deposits are insured by the FDIC. Customers may withdraw deposits in an effort to ensure that the amount they have on deposit with their bank is fully insured. Decreases in deposits may adversely affect our funding costs and net income. Ultimately, competition can and does increase our cost of funds, reduce loan yields and drive down our net interest margin, thereby reducing profitability. It can also make it more difficult for us to continue to increase the size of our loan portfolio and deposit base, and could cause us to rely more heavily on wholesale borrowings, which are generally more expensive than deposits.

**If we are not able to successfully keep pace with technological changes affecting the industry, our business could be hurt.** The financial services industry is constantly undergoing technological change, with the frequent introduction of new technology-driven products and services. The effective use of technology increases efficiency and enables financial institutions to better service clients and reduce costs. Our future success depends, in part, upon our ability to respond to the needs of our clients by using technology to provide desired products and services and create additional efficiencies within our operations. Some 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 clients. Failure to successfully keep pace with technological change in the financial services industry could have a material adverse impact on our business and, in turn, on our financial condition and results of operations.

**If our information systems were to experience a system failure or a breach in security, our business and reputation could suffer.** We rely heavily on communications and information systems to conduct our business. The computer systems and network infrastructure we use could be vulnerable to unforeseen problems. Our operations are dependent upon our ability to minimize service disruptions by protecting our computer equipment, systems, and network infrastructure from physical damage due to fire, power loss, telecommunications failure or a similar catastrophic event. In addition, we must be able to protect against unauthorized system breaches that could jeopardize the security of customer information and other proprietary data. We have protective measures in place to prevent or limit the effect of the failure, interruption or security breach of our information systems and will continue to implement security technology and monitor and update operational procedures to prevent such damage. However, if such failures, interruptions or security breaches were to occur, they could result in damage to our reputation, a loss of customers, increased regulatory scrutiny, or possible exposure to financial liability, any of which could have a material adverse effect on our financial condition and results of operations.

**We are subject to a variety of operational risks, including reputational risk, legal risk, compliance risk, the risk of fraud or theft by employees or outsiders, and the risk of clerical or record-keeping errors, which may adversely affect our business and results of operations.** If personal, non-public, confidential or proprietary information of customers in our possession were to be mishandled or misused, we could suffer significant regulatory consequences, reputational damage and financial loss. Such mishandling or misuse could occur, for example, if information were erroneously provided to parties who are not permitted to have the information, either by fault of our systems, employees, or counterparties, or where such information is intercepted or otherwise inappropriately taken by third parties.

Because the nature of the financial services business involves a high volume of transactions, certain errors may be repeated or compounded before they are discovered and successfully remediated. Our necessary dependence upon automated systems to record and process transactions and our large transaction volume may further increase the risk that technical flaws or employee tampering or manipulation of those systems could result in losses that are difficult to detect. We also may be subject to disruptions of our operating systems arising from events that are wholly or partially beyond our control (for example, computer viruses or electrical or telecommunications outages, or natural disasters, disease pandemics or other damage to property or physical assets) which may give rise to disruption of service to customers and to financial loss or liability. We are further exposed to the risk that our external vendors may be unable to fulfill their contractual obligations (or will be subject to the same risk of fraud or operational errors by their respective employees as we are) and to the risk that our (or our vendors') business continuity and data security systems prove to be inadequate. The occurrence of any of these risks could result in a diminished ability to operate our business (for example, by requiring us to expend significant resources to correct the defect), as well as potential liability to clients, reputational damage and regulatory intervention, which could adversely affect our business, financial condition and results of operations, perhaps materially.

**Previously enacted and potential future financial regulatory reforms could have a significant impact on our business, financial condition and results of operations.** The Dodd-Frank Wall Street Reform and Consumer Protection Act was enacted in July 2010. Dodd-Frank is expected to have a broad impact on the financial services industry, including significant regulatory and compliance changes. Many of the requirements called for in Dodd-Frank will be implemented over time and most will be subject to implementing regulations over the course of several years.

Given the uncertainty associated with the manner in which the provisions of Dodd-Frank will be implemented, the full extent to which they will impact our operations is unclear. The changes resulting from Dodd-Frank may impact the profitability of business activities, require changes to certain business practices, impose more stringent capital, liquidity and leverage requirements or otherwise adversely affect our business. In particular, the potential impact of Dodd-Frank on our operations and activities, both currently and prospectively, include, among others:

- an increase in the cost of operations due to greater regulatory oversight, supervision and examination of banks and bank holding companies, and higher deposit insurance premiums;
- the limitation of our ability to expand consumer product and service offerings due to anticipated stricter consumer protection laws and regulations;

- a material negative impact on our cost of funds when market interest rates increase, if pursuant to the authorization for financial institutions to pay interest on business checking accounts we decide to offer such a product on a broad scale for competitive reasons;
- a potential reduction in fee income, due to limits on interchange fees applicable to larger institutions which could ultimately lead to a competitive-driven reduction in the fees we charge;
- a potential increase in competition due to the elimination of remaining barriers to de novo interstate branching; and
- the limitation of our ability to raise new capital through the use of trust preferred securities, as any new issuances of these securities are not includible as Tier 1 capital.

Further, we may be required to invest significant management attention and resources to evaluate and make any changes necessary to comply with new statutory and regulatory requirements under the Dodd-Frank Act, which may negatively impact results of operations and financial condition. Additionally, we cannot predict whether there will be additional laws or reforms that would affect the U.S. financial system or financial institutions, when such changes may be adopted, how such changes may be interpreted and enforced or how such changes may affect us. However, the costs of complying with any additional laws or regulations could have a material adverse effect on our financial condition and results of operations.

**We may be adversely affected by the soundness of other financial institutions.** Our ability to engage in routine funding transactions could be adversely affected by the actions and liquidity of other financial institutions. Financial institutions are often interconnected as a result of trading, clearing, counterparty, or other business relationships. We have exposure to many different industries and counterparties, and routinely execute transactions with counterparties in the financial services industry, including commercial banks, brokers and 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. Even if the transactions are collateralized, credit risk could exist if the collateral held by us cannot be liquidated at prices sufficient to recover the full amount of the credit or derivative exposure due to us. Any such losses could adversely affect our business, financial condition or results of operations.

**Changes in interest rates could adversely affect our profitability, business and prospects.** Net interest income, and therefore earnings, can be adversely affected by differences or changes in the base interest rates on, or the re-pricing frequency of, our interest-bearing liabilities and interest-earning assets. In addition, fluctuations in interest rates can affect the demand of customers for products and services, and an increase in the general level of interest rates may adversely affect the ability of certain borrowers to make variable-rate loan payments. Accordingly, changes in market interest rates could materially and adversely affect the Company’s asset quality, loan origination volume, financial condition, results of operations, and cash flows. This interest rate risk can arise from Federal Reserve Board monetary policies, as well as other economic, regulatory and competitive factors that are beyond our control.

**We depend on our executive officers and key personnel to implement our business strategy, and could be harmed by the loss of their services.** We believe that our continued growth and success depends in large part upon the skills of our management team and other key personnel. The competition for qualified personnel in the financial services industry is intense, and the loss of key personnel or an inability to continue to attract, retain or motivate key personnel could adversely affect our business. If we are not able to retain our existing key personnel or attract additional qualified personnel, our business operations would be hurt. None of our executive officers have employment agreements.

**The value of the securities in our investment portfolio may be negatively affected by continued disruptions in securities markets**. The market for some of the investment securities held in our portfolio has experienced volatility and disruption for the last several years. These market conditions may have a detrimental effect on the value of our securities, such as reduced valuations because of the perception of heightened credit risks or due to illiquid markets for certain securities. There can be no assurance that the declines in market value associated with these disruptions will not result in other-than-temporary impairments of these assets, which would lead to accounting charges that could have a material adverse effect on our results of operations and capital levels.

**We are exposed to the risk of environmental liabilities with respect to properties to which we obtain title**. Approximately 62% of our loan portfolio at December 31, 2012 consisted of real estate loans. In the normal course of 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 parties 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, if we are 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. These costs and claims could adversely affect our business and prospects.

Risks Related to our Common Stock

**The price of our common stock may fluctuate significantly, and this may make it difficult for you to sell shares of common stock at times or at prices you find attractive.** The trading price of our common stock could be impacted by a number of factors, many of which are outside our control. In addition, the stock market in general is subject to fluctuations that affect the share prices and trading volumes of many companies, and these broad market fluctuations could adversely affect the market price of our common stock. Factors that could affect our common stock price in the future include but are not necessarily limited to the following:

- actual or anticipated fluctuations in our reported operating results and financial condition;
- changes in revenue or earnings estimates or publication of research reports and recommendations by financial analysts;
- failure to meet analysts’ revenue or earnings estimates;
- speculation in the press or investment community;
- strategic actions by us or our competitors, such as acquisitions or restructurings;
- actions by shareholders;
- sales of our equity or equity-related securities, or the perception that such sales may occur;
- fluctuations in the trading volume of our common stock;
- fluctuations in the stock prices, trading volumes, and operating results of our competitors;
- general market conditions and, in particular, market conditions for the financial services industry;
- proposed or adopted regulatory changes or developments;
- regulatory action against us;
- anticipated or pending investigations, proceedings, or litigation that involve or affect us; and
- domestic and international economic factors unrelated to our performance.

The stock market and, in particular, the market for financial institution stocks, has experienced significant volatility in recent years. As a result, the market price of our common stock has been, and could continue to be, volatile. The capital and credit markets have been experiencing volatility and disruption for several years, at times reaching unprecedented levels. In some cases, the markets have produced downward pressure on stock prices and credit availability for certain issuers without regard to the issuers’ underlying financial strength.

**We may pursue additional capital in the future, which may not be available on acceptable terms or at all, could dilute the holders of our outstanding common stock, and may adversely affect the market price of our common stock.** Our ability to raise additional capital, if needed, will depend on, among other things, conditions in the capital markets at the time, which are outside of our control, and our financial performance. We cannot provide any assurance that such capital will be available to us on acceptable terms or at all. Any such capital raising alternatives could dilute the holders of our outstanding common stock, and may adversely affect the market price of our common stock and our performance measures such as earnings per share.

**The Company relies heavily on the payment of dividends from the Bank.** Other than $1.7 million in cash available at the holding company level at December 31, 2012, the Company's ability to meet debt service requirements and to pay dividends depends on the Bank's ability to pay dividends to the Company, as the Company has no other source of significant income. However, the Bank is subject to regulations limiting the amount of dividends it may pay. For example, the payment of dividends by the Bank is affected by the requirement to maintain adequate capital pursuant to the capital adequacy guidelines issued by the Federal Deposit Insurance Corporation. All banks and bank holding companies are required to maintain a minimum ratio of qualifying total capital to total risk-weighted assets of 8%, at least one-half of which must be in the form of Tier 1 capital, and a ratio of Tier 1 capital to average adjusted assets of 4%. If (i) any of these required ratios are increased; (ii) the total risk-weighted assets of the Bank increase significantly; and/or (iii) the Bank's income declines significantly, the Bank's Board of Directors may decide or be required to retain a greater portion of the Bank's earnings to achieve and maintain the required capital or asset ratios. This would reduce the amount of funds available for the payment of dividends by the Bank to the Company. Further, one or more of the Bank's regulators could prohibit the Bank from paying dividends if, in their view, such payments would constitute unsafe or unsound banking practices. The Bank's ability to pay dividends to the Company is also limited by the California Financial Code. Whether dividends are paid and their frequency and amount will also depend on the financial condition and performance of the Bank, and the discretion of the Bank's Board of Directors. Information concerning the Company's dividend policy and historical dividend practices is set forth in Item 5 below under "Dividends." However, no assurance can be given that our future performance will justify the payment of dividends in any particular year.

**You may not be able to sell your shares at the times and in the amounts you want if the trading market for our stock is not active.** Although our stock has been listed on NASDAQ for many years, trading in our stock does not consistently occur in high volumes and cannot always be characterized as an active trading market. A limited trading market for our common stock may exaggerate fluctuations in the value of our common stock, leading to price volatility in excess of that which would occur in a more active trading market.

**Your investment may be diluted because of our ability to offer stock to others, and from the exercise of stock options.** The shares of our common stock do not have preemptive rights. This means that you may not be entitled to buy additional shares if shares are offered to others in the future. We are authorized to issue 24,000,000 shares of common stock, and as of December 31, 2012 we had 14,106,959 shares of our common stock outstanding. Except for certain limitations imposed by NASDAQ, nothing restricts our ability to offer additional shares of stock for fair value to others in the future. Any issuances of common stock would dilute our shareholders' ownership interests and may dilute the per share book value of our common stock.

In addition, when our directors and officers exercise in-the-money stock options your ownership in the Company is diluted. As of December 31, 2012, there were outstanding options to purchase an aggregate of 926,950 shares of our common stock with an average exercise price of $14.16 per share. At the same date there were an additional 733,640 shares available for grant under our 2007 Stock Incentive Plan.

**Shares of our preferred stock issued in the future could have dilutive and other effects on our common stock.** Our Articles of Incorporation authorize us to issue 10,000,000 shares of preferred stock, none of which is presently outstanding. Although our Board of Directors has no present intent to authorize the issuance of shares of preferred stock, such shares could be authorized in the future. If such shares of preferred stock are made convertible into shares of common stock, there could be a dilutive effect on the shares of common stock then outstanding. In addition, shares of preferred stock may be provided a preference over holders of common stock upon our liquidation or with respect to the payment of dividends, in respect of voting rights or in the redemption of our common stock. The rights, preferences, privileges and restrictions applicable to any series or preferred stock would be determined by resolution of our Board of Directors.

**The holders of our debentures have rights that are senior to those of our shareholders.** In 2004 we issued \$15,464,000 of junior subordinated debt securities due March 17, 2034, and in 2006 we issued an additional \$15,464,000 of junior subordinated debt securities due September 23, 2036 in order to supplement regulatory capital. These junior subordinated debt securities are senior to the shares of our common stock. As a result, we must make interest payments on the debentures before any dividends can be paid on our common stock, and in the event of our bankruptcy, dissolution or liquidation, the holders of the debt securities must be paid in full before any distributions may be made to the holders of our common stock. In addition, we have the right to defer interest payments on the junior subordinated debt securities for up to five years, during which time no dividends may be paid to holders of our common stock. In the event that the Bank is unable to pay dividends to us, then we may be unable to pay the amounts due to the holders of the junior subordinated debt securities and, thus, we would be unable to declare and pay any dividends on our common stock.

23

**Provisions in our articles of incorporation could delay or prevent changes in control of our corporation or our management.** Our articles of incorporation contain provisions for staggered terms of office for members of the board of directors; no cumulative voting in the election of directors; and the requirement that our board of directors consider the potential social and economic effects on our employees, depositors, customers and the communities we serve as well as certain other factors, when evaluating a possible tender offer, merger or other acquisition of the Company. These provisions make it more difficult for another company to acquire us, which could cause our shareholders to lose an opportunity to be paid a premium for their shares in an acquisition transaction, and reduce the current and future market price of our common stock.

## ITEM 1B. UNRESOLVED STAFF COMMENTS

Not applicable.

## Item 2. Properties

The Company's administrative headquarters is located at 86 North Main Street, Porterville, California, in a 37,000 square feet, three-story office building of which the Company is sole occupant. The Company purchased this office building in December 2011 in a cash transaction, from parties unrelated to the Company. The Company's main office is located at 90 N. Main Street, Porterville, California, adjacent to its administrative headquarters, and consists of a one-story brick building on unencumbered property owned by us. The Company also owns unencumbered property on which 14 of our other offices are located, namely the following branches: Porterville West Olive, Bakersfield Ming, California City, Dinuba, Exeter, Farmersville, Fresno Shaw, Hanford, Lindsay, Tehachapi Downtown, Tehachapi Old Town, Three Rivers, Tulare, and Visalia Mooney. The remaining branches, as well as our technology center in Porterville and our six remote ATM locations, are all leased from unrelated parties. While limited branch expansion is planned over the course of the next few years, management believes that existing back-office facilities are adequate to accommodate the Company's operations for the immediately foreseeable future.

## Item 3. Legal Proceedings

From time to time, the Company is a party to claims and legal proceedings arising in the ordinary course of business. After taking into consideration information furnished by counsel to the Company as to the current status of these claims or proceedings to which the Company is a party, management is of the opinion that the ultimate aggregate liability represented thereby, if any, will not have a material adverse affect on the financial condition of the Company.

**Item 4. RESERVED**

## PART II

Item 5. Market for REGISTRANT’S Common Equity, Related Shareholder Matters AND ISSUER PURCHASES OF EQUITY SECURITIES

**(a) Market Information**

Sierra Bancorp’s Common Stock trades on the NASDAQ Global Select Market under the symbol BSRR, and the CUSIP number for our stock is #82620P102. Trading in the Company’s Common Stock has not consistently occurred in high volumes, and such trading activity cannot always be characterized as constituting an active trading market. The following table summarizes trades of the Company’s Common Stock, setting forth the approximate high and low sales prices and volume of trading for the periods indicated, based upon information provided by public sources.

| Calendar Quarter Ended | Sale Price of the Company's Common Stock (per share) High | Low | Approximate Trading Volume In Shares |
|---|---|---|---|
| March 31, 2011 | $ 11.20 | $ 10.38 | 1,444,602 |
| June 30, 2011 | $ 11.73 | $ 10.58 | 1,233,723 |
| September 30, 2011 | $ 11.70 | $ 8.47 | 1,499,721 |
| December 31, 2011 | $ 11.49 | $ 8.51 | 1,744,827 |
| March 31, 2012 | $ 10.21 | $ 8.73 | 1,472,347 |
| June 30, 2012 | $ 10.20 | $ 8.42 | 1,302,810 |
| September 30, 2012 | $ 13.00 | $ 9.35 | 1,218,617 |
| December 31, 2012 | $ 12.72 | $ 9.80 | 1,437,301 |

(b) Holders

As of January 31, 2013 there were approximately 4,001 shareholders of the Company's Common Stock. Per our stock transfer agent there were 562 registered holders of record, and per Broadridge, an investor communication company, there were approximately 3,439 beneficial holders with shares being held under a street name on that date, including "objecting beneficial owners" whose names and addresses are unavailable.

**(c) Dividends**

The Company paid cash dividends totaling $3.4 million, or $0.24 per share in 2012 and 2011, representing 41% of annual net earnings for dividends paid in 2012 and 43% in 2011. The Company's general dividend policy is to pay cash dividends within the range of typical peer payout ratios, provided that such payments do not adversely affect the Company's financial condition and are not overly restrictive to its growth capacity. However, at a time when many of our peers elected to suspend dividend payments, at least temporarily, the Company's Board also concluded that a certain level of dividend should be maintained as long as our core operating performance remains adequate and policy or regulatory restrictions do not preclude such payments, without regard to peer payout ratios. While we maintained a consistent level of quarterly dividends in 2011 and 2012, no assurance can be given that our financial performance in any given year will justify the continued payment of a certain level of cash dividend, or any cash dividend at all.

As a bank holding company that currently has no significant assets other than its equity interest in the Bank, the Company's ability to declare dividends depends upon cash on hand as supplemented by dividends it might receive from the Bank. The Bank's dividend practices in turn depend upon the Bank's earnings, financial position, current and anticipated capital requirements, and other factors deemed relevant by the Bank's Board of Directors at that time. The power of the Bank's Board of Directors to declare cash dividends is also subject to statutory and regulatory restrictions. Under California banking law, the Bank may declare dividends in an amount not exceeding the lesser of its retained earnings or its net income for the last three years (reduced by dividends paid during such period) or, with the prior approval of the California Commissioner of Financial Institutions, in an amount not exceeding the greatest of (i) the retained earnings of the Bank, (ii) the net income of the Bank for its last fiscal year, or (iii) the net income of the Bank for its current fiscal year. The payment of any cash dividends by the Bank will depend not only upon the Bank's earnings during a specified period, but also on the Bank meeting certain regulatory capital requirements.

The Company's ability to pay dividends is also limited by state law. The California General Corporation Law allows a California corporation to pay dividends if the company's retained earnings equal at least the amount of the proposed dividend. If a California corporation does not have sufficient retained earnings available for the proposed dividend, it may still pay a dividend to its shareholders if immediately after the dividend the sum of the company's assets (exclusive of goodwill and deferred charges) would be at least equal to 125% of its liabilities (not including deferred taxes, deferred income and other deferred liabilities) and the current assets of the company would be at least equal to its current liabilities, or, if the average of its earnings before taxes on income and before interest expense for the two preceding fiscal years was less than the average of its interest expense for the two preceding fiscal years, at least equal to 125% of its current liabilities. In addition, during any period in which the Company has deferred payment of interest otherwise due and payable on its subordinated debt securities, it may not make any dividends or distributions with respect to its capital stock (see "Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations – Capital Resources").

**(d) Securities Authorized for Issuance under Equity Compensation Plans**

The following table provides information as of December 31, 2012, with respect to options outstanding and available under our 2007 Stock Incentive Plan and the now-terminated 1998 Stock Option Plan, which are our only equity compensation plans other than an employee benefit plan meeting the qualification requirements of Section 401(a) of the Internal Revenue Code:

| Plan Category | Number of Securities to be Issued Upon Exercise of Outstanding Options | Weighted-Average Exercise Price of Outstanding Options | Number of Securities Remaining Available for Future Issuance |
|---|---|---|---|
| Equity compensation plans approved by security holders | 926,950 | $ 14.16 | 733,640 |

**(e) Performance Graph**

The following is a five-year performance graph comparing the total cumulative shareholder return on the Company’s common stock to the cumulative total returns of the NASDAQ Composite Index (a broad equity market index), the SNL Bank Index, and the SNL $1 billion to $5 billion (asset size) Bank Index (the latter two qualifying as peer bank indices), assuming a $100 investment on December 31, 2007 and reinvestment of dividends:

| | ***Period Ending*** | | | | | |
|---|---|---|---|---|---|---|
| Index | 12/31/07 | 12/31/08 | 12/31/09 | 12/31/10 | 12/31/11 | 12/31/12 |
| Sierra Bancorp | 100.00 | 87.16 | 32.84 | 47.16 | 39.55 | 52.62 |
| NASDAQ Composite | 100.00 | 60.02 | 87.24 | 103.08 | 102.26 | 120.42 |
| SNL Bank $1B-$5B | 100.00 | 82.94 | 59.45 | 67.39 | 61.46 | 75.78 |
| SNL Bank | 100.00 | 57.06 | 56.47 | 63.27 | 49.00 | 66.13 |

***Source : SNL Financial LC, Charlottesville, VA***

**(f) Stock Repurchases**

The Company has a non-expiring stock repurchase program that became effective July 1, 2003, under which all share repurchases are executed in accordance with SEC Rule 10b-18. The amount available for repurchase has been supplemented from time to time, as deemed appropriate by the Board of Directors. There were no stock repurchases during the fourth quarter of 2012, leaving 100,669 shares available for repurchase as of December 31, 2012. The Company has not repurchased any shares for the past few years due to economic uncertainties and the perceived need for capital preservation. However, in January 2013, the Board reactivated the Company’s stock repurchase plan and increased the total number of shares authorized for repurchase to 700,000, or approximately 5% of total issued and outstanding shares.

Item 6. Selected Financial Data

The following table presents selected historical financial information concerning the Company, which should be read in conjunction with our audited consolidated financial statements, including the related notes and “Management’s Discussion and Analysis of Financial Condition and Results of Operations,” included elsewhere herein. The selected financial data as of December 31, 2012 and 2011, and for each of the years in the three year period ended December 31, 2012, is derived from our audited consolidated financial statements and related notes which are included in this Annual Report. The selected financial data presented for earlier years is derived from our audited financial statements which are not included in this Annual Report. Throughout this Annual Report, information is for the consolidated Company unless otherwise stated.

**Selected Financial Data**

(dollars in thousands, except per share data)

| | As of and for the years ended December 31, | | | | |
|---|---|---|---|---|---|
| Income Statement Summary | 2012 | 2011 | 2010 | 2009 | 2008 |
| Interest income | $54,902 | $58,614 | $63,831 | $70,146 | $77,938 |
| Interest expense | 4,321 | 5,657 | 7,649 | 12,177 | 21,329 |
| Net interest income before provision for loan losses | 50,581 | 52,957 | 56,182 | 57,969 | 56,609 |
| Provision for loan losses | 14,210 | 12,000 | 16,680 | 21,574 | 19,456 |
| Non-interest income | 18,126 | 14,992 | 19,265 | 17,279 | 15,987 |
| Non-interest expense | 46,656 | 47,605 | 51,638 | 44,138 | 35,859 |
| Income before provision for income taxes | 7,841 | 8,344 | 7,129 | 9,536 | 17,281 |
| Provision for income taxes | (344) | 564 | (234) | 608 | 3,868 |
| Net Income | 8,185 | 7,780 | 7,363 | 8,928 | 13,413 |
| | | | | | |
| Balance Sheet Summary | | | | | |
| Total loans, net | 867,078 | 740,929 | 783,601 | 859,875 | 929,629 |
| Allowance for loan losses | (13,873) | (17,283) | (21,138) | (23,715) | (15,094) |
| Securities available for sale | 380,188 | 406,471 | 331,730 | 278,168 | 243,413 |
| Cash and due from banks | 61,818 | 63,036 | 42,435 | 66,234 | 46,010 |
| Federal funds sold | - | - | 210 | - | 5,500 |
| Foreclosed Assets | 19,754 | 15,364 | 20,691 | 25,654 | 7,127 |
| Premises and equipment, net | 21,830 | 20,721 | 20,190 | 20,069 | 19,280 |
| Total Interest-Earning assets | 1,279,932 | 1,185,647 | 1,137,805 | 1,194,700 | 1,200,603 |
| Total Assets | 1,437,903 | 1,335,405 | 1,286,571 | 1,335,549 | 1,326,292 |
| Total Interest-Bearing liabilities | 895,434 | 852,308 | 860,944 | 953,156 | 974,177 |
| Total Deposits | 1,174,034 | 1,086,268 | 1,052,274 | 1,125,432 | 1,061,498 |
| Total Liabilities | 1,264,011 | 1,166,841 | 1,126,974 | 1,201,069 | 1,219,492 |
| Total Shareholders' Equity | 173,892 | 168,564 | 159,597 | 134,480 | 106,800 |
| Per Share Data | | | | | |
| Net Income Per Basic Share | 0.58 | 0.55 | 0.61 | 0.86 | 1.40 |
| Net Income Per Diluted Share | 0.58 | 0.55 | 0.60 | 0.86 | 1.37 |
| Book Value | 12.33 | 11.95 | 11.42 | 11.57 | 11.04 |
| Cash Dividends | 0.24 | 0.24 | 0.24 | 0.40 | 0.68 |
| Weighted Average Common Shares Outstanding Basic | 14,103,805 | 14,036,667 | 12,109,717 | 10,343,502 | 9,607,184 |
| Weighted Average Common Shares Outstanding Diluted | 14,120,313 | 14,085,201 | 12,192,345 | 10,415,084 | 9,779,657 |
| Key Operating Ratios: | | | | | |
| Performance Ratios: | | | | | |
| Return on Average Equity (1) | 4.74 % | 4.73 % | 5.16 % | 7.56 % | 12.86 % |
| Return on Average Assets (2) | 0.59 % | 0.59 % | 0.56 % | 0.68 % | 1.05 % |
| Net Interest Spread (tax-equivalent) (3) | 4.08 % | 4.41 % | 4.72 % | 4.74 % | 4.52 % |

| | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| Net Interest Margin (tax-equivalent) | 4.22 | % | 4.58 | % | 4.89 | % | 5.00 | % | 4.98 | % |
| Dividend Payout Ratio (4) | 41.35 | % | 43.29 | % | 39.86 | % | 46.76 | % | 48.73 | % |
| Equity to Assets Ratio (5) | 12.51 | % | 12.37 | % | 10.82 | % | 9.03 | % | 8.12 | % |
| Efficiency Ratio (tax-equivalent) | 66.81 | % | 67.83 | % | 67.25 | % | 57.69 | % | 48.73 | % |
| Net Loans to Total Deposits at Period End | 73.85 | % | 68.21 | % | 74.47 | % | 76.40 | % | 87.58 | % |
| Asset Quality Ratios: | | | | | | | | | | |
| Non-Performing Loans to Total Loans | 6.03 | % | 7.41 | % | 5.71 | % | 5.31 | % | 3.15 | % |
| Non-Performing Assets to Total Loans and | | | | | | | | | | |
| Other Real Estate Owned | 8.10 | % | 9.25 | % | 8.08 | % | 7.98 | % | 3.87 | % |
| Net Charge-offs (recoveries) to Average Loans | 2.23 | % | 2.06 | % | 2.26 | % | 1.40 | % | 1.79 | % |
| Allowance for Loan Losses to | | | | | | | | | | |
| Net Loans at Period End | 1.60 | % | 2.33 | % | 2.70 | % | 2.76 | % | 1.62 | % |
| Allowance for Loan Losses to Non-Performing Loans | 26.13 | % | 30.80 | % | 46.00 | % | 50.49 | % | 50.67 | % |
| Capital Ratios: | | | | | | | | | | |
| Tier 1 Capital to Adjusted Total Assets | 13.34 | % | 14.11 | % | 13.84 | % | 11.91 | % | 9.92 | % |
| Tier 1 Capital to Total Risk-weighted Assets | 18.11 | % | 20.46 | % | 19.06 | % | 15.41 | % | 12.34 | % |
| Total Capital to Total Risk-weighted Assets | 19.36 | % | 21.72 | % | 20.33 | % | 16.67 | % | 13.59 | % |

(1) Net income divided by average shareholders' equity.

(2) Net income divided by average total assets.

(3) Represents the average rate earned on interest-earning assets less the average rate paid on interest-bearing liabilities.

(4) Total dividends paid divided by net income.

(5) Average equity divided by average total assets.

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

This discussion presents Management's analysis of the financial condition of the Company as of December 31, 2012 and December 31, 2011, and the results of operations for each of the years in the three-year period ended December 31, 2012. The discussion should be read in conjunction with the Consolidated Financial Statements of the Company and the Notes related thereto presented elsewhere in this Form 10-K Annual Report (see Item 8 below).

Statements contained in this report or incorporated by reference that are not purely historical are forward looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934 as amended, including the Company's expectations, intentions, beliefs, or strategies regarding the future. All forward-looking statements concerning economic conditions, growth rates, income, expenses, or other values which are included in this document are based on information available to the Company on the date noted, and the Company assumes no obligation to update any such forward-looking statements. It is important to note that the Company's actual results could materially differ from those in such forward-looking statements. Risk factors that could cause actual results to differ materially from those in forward-looking statements include but are not limited to those outlined previously in Item 1A.

Critical Accounting Policies

The Company's financial statements are prepared in accordance with accounting principles generally accepted in the United States. The financial information and disclosures contained within those statements are significantly impacted by Management's estimates and judgments, which are based on historical experience and various other assumptions that are believed to be reasonable under current circumstances. Actual results may differ from those estimates under divergent conditions.

Critical accounting policies are those that involve the most complex and subjective decisions and assessments, and have the greatest potential impact on the Company's stated results of operations. In Management's opinion, the Company's critical accounting policies deal with the following areas: the establishment of the Company's allowance for loan and lease losses, as explained in detail in Note 2 to the consolidated financial statements and in the "Provision for Loan Losses" and "Allowance for Loan and Lease Losses" sections of this discussion and analysis; the valuation of impaired loans and foreclosed assets, as discussed in Note 2 to the consolidated financial statements; income taxes and deferred tax assets and liabilities, especially with regard to the ability of the Company to recover deferred tax assets as discussed in the "Provision for Income Taxes" and "Other Assets" sections of this discussion and analysis; goodwill, which is evaluated annually for impairment based on the fair value of the Company and for which it has been determined that no impairment exists, as discussed in Note 2 to the consolidated financial statements and in the "Other Assets" section of this discussion and analysis; and equity-based compensation, which is discussed in greater detail in Note 2 to the consolidated financial statements contained herein. Critical accounting areas are evaluated on an ongoing basis to ensure that the Company's financial statements incorporate the most recent expectations with regard to these areas.

Summary of Performance

Recessionary conditions have led to relatively high credit costs, diminished lending activity, and associated earnings pressures at the Company for the past five years. There are signs of recovery in the national economy and in certain regions of California, including Kern County, but economic conditions have not yet materially improved in Tulare, Fresno, and Kings Counties. Industry-wide regulatory pressures on certain components of non-interest income have exacerbated the negative impact of the faltering economy on our financial performance in recent years. The Company recognized net income of $8.185 million in 2012 relative to $7.780 million in 2011 and $7.363 million in 2010, representing year-over-year increases in net income for both 2012 and 2011 but still coming in well below levels achieved in pre-recession years. Net income per diluted share was $0.58 for 2012, as compared to $0.55 for 2011 and $0.60 in 2010. The Company's return on average assets and return on average equity were 0.59% and 4.74%, respectively, in 2012, as compared to 0.59% and 4.73%, respectively, for 2011, and 0.56% and 5.16%, respectively, in 2010.

The following are some of the major factors impacting the Company's results of operations for the years presented in the consolidated financial statements:

- **Net interest income has been declining, falling by 4% in 2012 relative to 2011 and by 6% in 2011 relative to 2010, due to net interest margin compression.** Negative factors affecting the Company's net interest margin in recent years include relatively strong growth in lower-yielding investment balances (although that trend began to reverse in the second half of 2012), a higher level of non-accruing loans and other non-earning assets, a shift from higher yielding loan categories to lower-yielding loan types, and lower loan yields across the board resulting from increased competition for quality loans.

- **Our loan loss provisions, which have been much higher than in pre-recession years, totaled $14.210 million in 2012, $12.000 million in 2011, and $16.680 million in 2010.** The elevated loan loss provisions have been utilized to establish specific reserves for impaired loans that have migrated into impaired status, replenish reserves subsequent to loan charge-offs, and build general reserves for performing loans due to higher historical loss factors.

- **Non-interest income increased by $3.134 million, or 21%, in 2012 over 2011, but declined by $4.273 million, or 22%, in 2011 relative to 2010.** Significant fluctuations in non-interest income in 2012 were created by non-recurring adjustments that lowered costs associated with tax credit investments and thus boosted income, an increase in bank-owned life insurance (BOLI) income associated with deferred compensation plans, an increase in debit card interchange fees, and the fact that we recorded an impairment charge on equity investment securities in 2011 that wasn't repeated in 2012. The drop in 2011 relative to 2010 was also impacted by the other-than-temporary impairment charge, as well as a sizeable decrease in overdraft fee income, a decline in BOLI income associated with deferred compensation plans, and a lower level of gains on the sale of investments. Gains on the sale of investment securities totaled $1.762 million in 2012, $1.660 million in 2011, and $2.643 million in 2010.

- **Operating expense, while reflecting favorable trends in 2012 and 2011, has been elevated relative to pre-recession years due in large part to net OREO costs and other credit-related expenses.** The drop of $949,000, or 2%, in total operating expense in 2012 is due in large part to declining credit costs (including net foreclosed asset costs and lending-related legal expense), lower occupancy costs and lower marketing expense. The decline of $4.033 million, or 8%, in 2011 was due mainly to a reduced level of OREO write-downs and OREO operating expense, as well as lower FDIC assessments.

- **The Company had a tax benefit of $344,000 in 2012, a tax provision of $564,000 in 2011, and a tax benefit of $234,000 in 2010.** The tax benefits in 2012 and 2010 were primarily the result of lower taxable income relative to the Company's available tax credits, and a higher level of tax-exempt BOLI income.

The Company's assets totaled $1.438 billion at December 31, 2012, relative to total assets of $1.335 billion at December 31, 2011. Total liabilities were $1.264 billion at the end of 2012 compared to $1.167 billion at the end of 2011, and we had shareholders' equity totaling $174 million at December 31, 2012 relative to $169 million at December 31, 2011. The following summarizes key balance sheet changes during 2012:

- **Total assets increased by $102 million, or 8%.** Investment securities, cash, and balances due from banks declined by a combined $28 million, or 6%, but that drop was more than offset by an increase of $126 million, or 17%, in net loan balances. Our loan growth in 2012 came primarily from the expansion of mortgage warehouse lending and growth in agricultural loans (both ag production and ag real estate loans). The balance of foreclosed assets was also up by $4 million for the year.

- **Nonperforming assets ended 2012 with a balance of $73 million, an increase of $1 million, or 2%, for the year but still below the peak balance of $80 million reported at September 30, 2009.** The net increase for the year is comprised of the $4 million increase in foreclosed assets noted above, partially offset by a $3 million net reduction in loans on non-accrual status. We had been making significant progress in reducing the balance of nonperforming loans for most of 2012, but much of that improvement was reversed in the fourth quarter subsequent to the downgrade to non-accrual status of two large loan relationships totaling approximately $28 million. The Company's ratio of nonperforming assets to loans plus foreclosed assets fell to 8.10% at December 31, 2012 from 9.25% at December 31, 2011, due to the increase in gross loan balances.

- **Our allowance for loan and lease losses was $13.9 million as of December 31, 2012, a decline of $3.4 million, or 20%, relative to year-end 2011.** The drop during 2012 was due in part to certain loan charge-offs which were taken against previously-established specific reserves and thus did not require replenishment, as well as a reduction in general reserves consistent with improvement in the quality of the Company's performing loans. Due to the decline in the overall allowance and the increase in total loans, the allowance fell to 1.58% of total loans at December 31, 2012 from 2.28% at December 31, 2011. Pursuant to management's detailed analysis, the allowance as of the end of 2012 is expected to be sufficient to cover specifically identified probable losses on impaired loans and leases, as well as probable incurred losses inherent in the remaining loan portfolio.

- **Total deposits increased by $88 million, or 8%, during 2012.** Non-maturity deposits were up $100 million, or 14%, including significant increases in savings deposits, non-interest bearing demand deposits, and interest-bearing transaction accounts due in part to aggressive deposit acquisition programs and an intensified focus on business relationships. A drop in time deposits partially offset the increase in non-maturity deposits.

- **Total capital was $174 million at December 31, 2012, reflecting an increase of $5 million, or 3%, for the year.** Risk-based capital ratios declined, however, as capital was leveraged for organic loan growth. At December 31, 2012, the consolidated Company's Total Risk-Based Capital Ratio was 19.36%, its Tier One Risk-Based Capital Ratio was 18.11%, and its Tier One Leverage Ratio was 13.34%.

## Results of Operations

The Company earns income from two primary sources. The first is net interest income, which is interest income generated by earning assets less interest expense on deposits and other borrowed money. The second is non-interest income, which primarily consists of customer service charges and fees but also comes from non-customer sources such as bank-owned life insurance. The majority of the Company's non-interest expenses are operating costs that relate to providing a full range of banking services to our customers.

### *Net Interest Income and Net Interest Margin*

Net interest income was $50.581 million in 2012, compared to $52.957 million in 2011 and $56.182 million in 2010. This represents declines of 4% in 2012 and 6% in 2011. The level of net interest income depends on several factors in combination, including but not necessarily limited to growth in earning assets, yields on earning assets, the cost of interest-bearing liabilities, the volume of earning assets relative to interest-bearing liabilities, and the mix of products which comprise the Company's earning assets, deposits, and other interest-bearing liabilities. Net interest income can also be impacted by the reversal of interest for loans placed on non-accrual status during the reporting period, and by the recovery of interest on loans that have been on non-accrual and are either sold or returned to accrual status.

The following Distribution, Rate and Yield table shows, for each of the past three years, the average balance of each significant balance sheet category and the amount of interest income or interest expense associated with each applicable category. The table also displays the calculated yields on each major component of the Company's investment and loan portfolios, the average rates paid on each key segment of the Company's interest-bearing liabilities, and our net interest margin.

| Distribution, Rate & Yield | Year Ended December 31, | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| (dollars in thousands, except per share data) | 2012 | | | 2011 | | | 2010 | |
| | Average Balance[1] | Income/ Expense | Average Rate/Yield[2] | Average Balance[1] | Income/ Expense | Average Rate/Yield[2] | Average Balance[1] | Inc Ex |
| Assets | | | | | | | | |
| Investments: | | | | | | | | |
| Federal funds sold/Due from time | $26,558 | $70 | 0.26% | $25,930 | $68 | 0.26% | $14,066 | $4 |
| Taxable | 335,553 | 6,280 | 1.87% | 319,635 | 8,732 | 2.73% | 239,926 | 8 |
| Non-taxable | 77,646 | 2,703 | 5.36% | 73,108 | 2,834 | 5.96% | 68,858 | 2 |
| Equity | 1,755 | 84 | 4.79% | 1,508 | 21 | 1.39% | 1,473 | 9 |
| Total Investments | 441,512 | 9,137 | 2.40% | 420,181 | 11,655 | 3.14% | 324,323 | 1 |
| Loans and Leases:[3] | | | | | | | | |
| Agricultural | 17,231 | 760 | 4.41% | 13,847 | 648 | 4.68% | 10,137 | 5 |
| Commercial | 171,344 | 9,157 | 5.34% | 104,293 | 6,224 | 5.97% | 115,188 | 6 |
| Real Estate | 525,594 | 32,981 | 6.27% | 553,063 | 35,970 | 6.50% | 612,001 | 4 |
| Consumer | 30,307 | 2,638 | 8.70% | 39,928 | 3,731 | 9.34% | 50,522 | 4 |
| Direct Financing Leases | 4,233 | 229 | 5.41% | 6,723 | 386 | 5.74% | 10,835 | 6 |
| Other | 40,624 | - | 0.00% | 50,047 | - | 0.00% | 52,609 | - |
| Total Loans and Leases | 789,333 | 45,765 | 5.80% | 767,901 | 46,959 | 6.12% | 851,292 | 5 |
| Total Interest Earning Assets[4] | 1,230,845 | 54,902 | 4.57% | 1,188,082 | 58,614 | 5.06% | 1,175,615 | 6 |
| Other Earning Assets | 6,579 | | | 7,735 | | | 8,984 | |
| Non-Earning Assets | 142,887 | | | 133,733 | | | 134,552 | |
| Total Assets | $1,380,311 | | | $1,329,550 | | | $1,319,151 | |
| | | | | | | | | |
| Liabilities and Shareholders' Equity | | | | | | | | |
| Interest Bearing Deposits: | | | | | | | | |
| Demand Deposits | $69,281 | $257 | 0.37% | $24,707 | $137 | 0.55% | $- | $- |
| NOW | 194,249 | 556 | 0.29% | 179,253 | 860 | 0.48% | 178,345 | 1 |
| Savings Accounts | 107,672 | 241 | 0.22% | 85,568 | 203 | 0.24% | 70,367 | 1 |
| Money Market | 78,775 | 127 | 0.16% | 132,208 | 506 | 0.38% | 162,619 | 9 |
| CDAR's | 17,999 | 52 | 0.29% | 36,335 | 199 | 0.55% | 70,661 | 6 |
| Certificates of Deposit<$100,000 | 106,403 | 619 | 0.58% | 142,753 | 1,001 | 0.70% | 162,418 | 1 |
| Certificates of Deposit≥$100,000 | 223,611 | 1,154 | 0.52% | 204,185 | 1,223 | 0.60% | 194,220 | 1 |
| Brokered Deposits | 15,000 | 202 | 1.35% | 12,986 | 176 | 1.36% | 10,885 | 2 |
| Total Interest Bearing Deposits | 812,990 | 3,208 | 0.39% | 817,995 | 4,305 | 0.53% | 849,515 | 6 |
| Borrowed Funds: | | | | | | | | |
| Federal Funds Purchased | - | - | - | 4 | - | 0.19% | 3 | - |
| Repurchase Agreements | 3,441 | 21 | 0.61% | 2,371 | 16 | 0.67% | - | - |
| Short Term Borrowings | 15,234 | 37 | 0.24% | 5,637 | 39 | 0.69% | 16,044 | 1 |
| Long Term Borrowings | 6,967 | 281 | 4.03% | 15,000 | 569 | 3.79% | 16,041 | 6 |
| TRUPS | 30,928 | 774 | 2.50% | 30,928 | 728 | 2.35% | 30,928 | 7 |
| Total Borrowed Funds | 56,570 | 1,113 | 1.97% | 53,940 | 1,352 | 2.51% | 63,016 | 1 |
| Total Interest Bearing Liabilities | 869,560 | 4,321 | 0.50% | 871,935 | 5,657 | 0.65% | 912,531 | 7 |
| Non-interest Bearing Demand Deposits | 319,501 | | | 276,363 | | | 246,949 | |
| Other Liabilities | 18,551 | | | 16,744 | | | 16,917 | |
| Shareholders' Equity | 172,699 | | | 164,508 | | | 142,754 | |
| Total Liabilities and Shareholders' Equity | $1,380,311 | | | $1,329,550 | | | $1,319,151 | |

| | | | | | |
|---|---|---|---|---|---|
| Interest Income/Interest Earning Assets | | 4.57% | | 5.06% | |
| Interest Expense/Interest Earning Assets | | 0.35% | | 0.48% | |
| **Net Interest Income and Margin(5)** | $50,581 | 4.22% | $52,957 | 4.58% | $5 |

(1) Average balances are obtained from the best available daily or monthly data and are net of deferred fees and related direct costs.

(2) Yields and net interest margin have been computed on a tax equivalent basis.

(3) Loans are gross of the allowance for possible loan losses. Net loan fees have been included in the calculation of interest income. Net loan Fees were $5,476, $(635,719) and $(491,045) for the years ended December 31, 2012, 2011, and 2010 respectively.

(4) Non-accrual loans have been included in total loans for purposes of total interest earning assets.

(5) Net interest margin represents net interest income as a percentage of average interest-earning assets (tax-equivalent).

The Volume and Rate Variances table below sets forth the dollar difference in interest earned or paid for each major category of interest-earning assets and interest-bearing liabilities for the comparative periods, and the amount of such change attributable to changes in average balances (volume) or changes in average interest rates. Volume variances are equal to the increase or decrease in average balance multiplied by prior period rates, and rate variances are equal to the increase or decrease in rate times prior period average balances. Variances attributable to both rate and volume changes are calculated by multiplying the change in rate by the change in average balance, and have been allocated to the rate variance.

| Volume & Rate Variances | Years Ended December 31, | | | | | |
|---|---|---|---|---|---|---|
| (dollars in thousands) | 2012 over 2011 | | | 2011 over 2010 | | |
| | Increase(decrease) due to | | | Increase(decrease) due to | | |
| | Volume | Rate | Net | Volume | Rate | Net |