

CVB FINANCIAL CORP
Form 10-K
March 01, 2007

Table of Contents

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

Form 10-K

- þ ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934.
For the fiscal year ended December 31, 2006**
- or**
- o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934.
For the transition period from N/A to N/A**

**Commission file number 1-10140
CVB FINANCIAL CORP.**

(Exact name of registrant as specified in its charter)

California
*(State or other jurisdiction of
incorporation or organization)*
701 N. Haven Avenue, Suite 350
Ontario, California
(Address of Principal Executive Offices)

95-3629339
*(I.R.S. Employer
Identification No.)*
91764
(Zip Code)

Registrant's telephone number, including area code (909) 980-4030

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

Title of Class	Name of Each Exchange on Which Registered
Common Stock, no par value	NASDAQ Stock Market, LLC
Preferred Stock Purchase Rights	NASDAQ Stock Market, LLC

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 No

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

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

Edgar Filing: CVB FINANCIAL CORP - Form 10-K

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, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act.

Large accelerated filer Accelerated Filer Non-accelerated filer

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

As of June 30, 2006, the aggregate market value of the common stock held by non-affiliates of the registrant was approximately \$899,009,320.

Number of shares of common stock of the registrant outstanding as of February 22, 2007: 84,283,333.

Documents Incorporated By Reference

Part of

Definitive Proxy Statement for the Annual Meeting of Stockholders which will be filed within 120 days of the fiscal year ended December 31, 2006

Part III of
Form 10-K

CVB FINANCIAL CORP.
2006 ANNUAL REPORT ON FORM 10-K

TABLE OF CONTENTS

PART I

<u>Item 1.</u>	<u>Business</u>	2
<u>Item 1A.</u>	<u>Risk Factors</u>	14
<u>Item 1B.</u>	<u>Unresolved Staff Comments</u>	17
<u>Item 2.</u>	<u>Properties</u>	17
<u>Item 3.</u>	<u>Legal Proceedings</u>	17
<u>Item 4.</u>	<u>Submission of Matters to a vote of Security Holders</u>	17

PART II

<u>Item 5.</u>	<u>Market for the Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities</u>	18
<u>Item 6.</u>	<u>Selected Financial Data</u>	20
<u>Item 7.</u>	<u>Management's Discussion and Analysis of Financial Condition and the Results of Operations</u>	21
	<u>General</u>	21
	<u>Overview</u>	21
	<u>Critical Accounting Policies and Estimates</u>	22
	<u>Analysis of the Results of Operations</u>	24
	<u>Analysis of Financial Condition</u>	33
	<u>Risk Management</u>	43
<u>Item 7A.</u>	<u>Quantitative and Qualitative Disclosures About Market Risk</u>	53
<u>Item 8.</u>	<u>Financial Statements and Supplementary Data</u>	54
<u>Item 9.</u>	<u>Changes in and Disagreements With Accountants on Accounting and Financial Disclosure</u>	54
<u>Item 9A.</u>	<u>Controls and Procedures</u>	54
<u>Item 9B.</u>	<u>Other Information</u>	56

PART III

<u>Item 10.</u>	<u>Directors, Executive Officers and Corporate Governance</u>	57
<u>Item 11.</u>	<u>Executive Compensation</u>	57
<u>Item 12.</u>	<u>Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters</u>	57
<u>Item 13.</u>	<u>Certain Relationships and Related Transactions, and Director Independence</u>	58
<u>Item 14.</u>	<u>Principal Accountant Fees and Services</u>	58

PART IV

<u>Item 15.</u>	<u>Exhibits and Financial Statement Schedules</u>	59
<u>EXHIBIT 10.23</u>		
<u>EXHIBIT 10.25</u>		
<u>EXHIBIT 10.26</u>		
<u>EXHIBIT 21</u>		
<u>EXHIBIT 23.1</u>		
<u>EXHIBIT 31.1</u>		

EXHIBIT 31.2
EXHIBIT 32.1
EXHIBIT 32.2
EXHIBIT 99.1

Table of Contents

INTRODUCTION

Certain statements in this report constitute forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities and Exchange Act of 1934, as amended, or Exchange Act, and as such involve risk and uncertainties. These forward-looking statements relate to, among other things, expectations of the environment in which we operate, projections of future performance, perceived opportunities in the market and strategies regarding our mission and vision. Our actual results may differ significantly from the results discussed in such forward-looking statements. Factors that might cause such a difference include but are not limited to economic conditions, competition in the geographic and business areas in which we conduct our operations, fluctuations in interest rates, credit quality and government regulation, and failure to obtain appropriate governmental or shareholder approval for the merger with First Coastal Bancshares or failure of any other condition of consummation of the merger. For additional information concerning these factors, see Item 1A. Risk Factors. And any additional information as set forth in our periodic reports filed pursuant to the Securities Exchange Act of 1934, as amended. We do not undertake any obligation to update our forward-looking statements to reflect occurrences or unanticipated events or circumstances arising after the date of such statement except as required by laws.

PART I

Item 1. Business

CVB Financial Corp.

CVB Financial Corp. (referred to herein on an unconsolidated basis as CVB and on a consolidated basis as we or the Company) is a bank holding company incorporated in California on April 27, 1981 and registered under the Bank Holding Company Act of 1956, as amended (the Bank Holding Company Act). The Company commenced business on December 30, 1981 when, pursuant to a reorganization, it acquired all of the voting stock of Chino Valley Bank. On March 29, 1996, Chino Valley Bank changed its name to Citizens Business Bank (the Bank). The Bank is our principal asset. The Company has three other inactive subsidiaries: CVB Ventures, Inc.; Chino Valley Bancorp; and ONB Bancorp. In March 2006, we merged two of our operating subsidiaries, Community Trust Deed Services and Golden West Enterprises, Inc. into the Bank to increase the lending limit of Golden West's leasing operations and to improve efficiency. The Company is also the common stockholder of CVB Statutory Trust I, CVB Statutory Trust II and CVB Statutory Trust III. CVB Statutory Trusts I and II were created in December 2003 and CVB Statutory Trust III was created in January 2006 to issue trust preferred securities in order to raise capital for the Company.

CVB's principal business is to serve as a holding company for the Bank and for other banking or banking related subsidiaries, which the Company may establish or acquire. We have not engaged in any other activities to date. As a legal entity separate and distinct from its subsidiaries, CVB's principal source of funds is, and will continue to be, dividends paid by and other funds advanced from the Bank. Legal limitations are imposed on the amount of dividends that may be paid and loans that may be made by the Bank to CVB. See Item 1. Business - Supervision and Regulation - Dividends and Other Transfers of Funds. At December 31, 2006, the Company had \$6.09 billion in total consolidated assets, \$3.07 billion in net loans and \$3.41 billion in deposits.

The principal executive offices of CVB and the Bank are located at 701 North Haven Avenue, Suite 350, Ontario, California. Our phone number is (909) 980-4030.

Citizens Business Bank

The Bank commenced operations as a California state chartered bank on August 9, 1974. The Bank's deposit accounts are insured under the Federal Deposit Insurance Act up to applicable limits. The Bank is not a member of the Federal

Edgar Filing: CVB FINANCIAL CORP - Form 10-K

Reserve System. At December 31, 2006, the Bank had \$6.09 billion in assets, \$3.07 billion in net loans and \$3.44 billion in deposits.

As of December 31, 2006, we had 39 Business Financial Centers located in the Inland Empire, San Gabriel Valley, Orange County, Los Angeles County, Madera County, Fresno County, Tulare County, and Kern County

Table of Contents

areas of California. Of the 39 offices, we opened twelve as de novo branches and acquired the other twenty-seven in acquisition transactions. We added five offices in 2003 and an additional three offices in 2005. During the second quarter of 2006, we consolidated two of our business financial centers in Arcadia and moved into a new location within the city.

Through our network of banking offices, we emphasize personalized service combined with a full range of banking and trust services for businesses, professionals and individuals located in the service areas of our offices. Although we focus the marketing of our services to small-and medium-sized businesses, a full range of retail banking services are made available to the local consumer market.

We offer a wide range of deposit instruments. These include checking, savings, money market and time certificates of deposit for both business and personal accounts. We also serve as a federal tax depository for our business customers.

We provide a full complement of lending products, including commercial, agribusiness, consumer, real estate loans and equipment and vehicle leasing. Commercial products include lines of credit and other working capital financing, accounts receivable lending and letters of credit. Agribusiness products are loans to finance the operating needs of wholesale dairy farm operations, cattle feeders, livestock raisers, and farmers. We provide lease financing for municipal governments. Financing products for consumers include automobile leasing and financing, lines of credit, and home improvement and home equity lines of credit. Real estate loans include mortgage and construction loans.

We also offer a wide range of specialized services designed for the needs of our commercial accounts. These services include cash management systems for monitoring cash flow, a credit card program for merchants, courier pick-up and delivery, payroll services, electronic funds transfers by way of domestic and international wires and automated clearinghouse, and on-line account access. We make available investment products to customers, including mutual funds, a full array of fixed income vehicles and a program to diversify our customers' funds in federally insured time certificates of deposit of other institutions.

We offer a wide range of financial services and trust services through our Financial Advisory Services Group (formerly known as Wealth Management Division). These services include fiduciary services, mutual funds, annuities, 401K plans and individual investment accounts.

Business Segments

We are a community bank with Business Financial Centers (branches) being the focal points for customer sales and services. As such, these Business Financial Centers comprise the biggest segment of the Company. The next largest business unit is the Treasury Department. This department manages all of the investments for the Company. As a result, we have two reportable operating segments consisting of Business Financial Centers and the Treasury Department. All administrative and other smaller operating departments are combined into Other category. See the sections captioned Results of Segment Operations in Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations and Note 19 Business Segments in the notes to consolidated financial statements.

Competition

The banking and financial services business is highly competitive. The increasingly competitive environment faced by banks is a result primarily of changes in laws and regulation, changes in technology and product delivery systems, and the accelerating pace of consolidation among financial services providers. We compete for loans, deposits, and customers with other commercial banks, savings and loan associations, savings banks, securities and brokerage companies, mortgage companies, insurance companies, finance companies, money market funds, credit unions, and

other nonbank financial service providers. Many competitors are much larger in total assets and capitalization, have greater access to capital markets, including foreign-ownership, and/or offer a broader range of financial services.

Table of Contents

Economic Conditions, Government Policies, Legislation, and Regulation

Our profitability, like most financial institutions, is primarily dependent on interest rate differentials. In general, the difference between the interest rates paid by us on interest-bearing liabilities, such as deposits and other borrowings, and the interest rates received by us on our interest-earning assets, such as loans to customers and securities held in the investment portfolio, will comprise the major portion of our earnings. These rates are highly sensitive to many factors that are beyond our control, such as inflation, recession and unemployment, and the impact which future changes in domestic and foreign economic conditions might have on us cannot be predicted.

Our business is also influenced by the monetary and fiscal policies of the federal government and the policies of regulatory agencies, particularly the Board of Governors of the Federal Reserve System (the FRB). The FRB implements national monetary policies (with objectives such as curbing inflation and combating recession) through its open-market operations in U.S. Government securities by adjusting the required level of reserves for depository institutions subject to its reserve requirements, and by varying the target federal funds and discount rates applicable to borrowings by depository institutions. The actions of the FRB in these areas influence the growth of bank loans, investments, and deposits and also affect interest earned on interest-earning assets and interest paid on interest-bearing liabilities. The nature and impact on us of any future changes in monetary and fiscal policies cannot be predicted.

From time to time, federal and state legislation is enacted which may have the effect of materially increasing the cost of doing business, limiting or expanding permissible activities, or affecting the competitive balance between banks and other financial services providers. We cannot predict whether or when potential legislation will be enacted, and if enacted, the effect that it, or any implementing regulations, would have on our financial condition or results of operations. In addition, the outcome of any investigations initiated by state authorities or litigation raising issues such as whether state laws are preempted by federal law may result in necessary changes in our operations, additional regulation and increased compliance costs.

Supervision and Regulation

General

We and our subsidiaries are extensively regulated under both federal and certain state laws. This regulation and supervision by the federal and state banking agencies is intended primarily for the protection of depositors and the deposit insurance fund and not for the benefit of stockholders. Set forth below is a summary description of key laws and regulations which relate to our operations. These descriptions are qualified in their entirety by reference to the applicable laws and regulations.

The Company

As a bank holding company, we are subject to regulation and examination by the FRB under the Bank Holding Company Act of 1956, as amended (the BHCA). We are required to file with the FRB periodic reports and such additional information as the FRB may require.

The FRB may require us to terminate an activity or terminate control of or liquidate or divest certain subsidiaries, affiliates or investments if the FRB believes the activity or the control of the subsidiary or affiliate constitutes a significant risk to the financial safety, soundness or stability of any bank subsidiary. The FRB also has the authority to regulate provisions of certain bank holding company debt, including the authority to impose interest ceilings and reserve requirements on such debt. Under certain circumstances, we must file written notice and obtain FRB approval prior to purchasing or redeeming our equity securities. Further, we are required by the FRB to maintain certain levels

of capital. See Capital Standards.

We are required to obtain prior FRB approval for the acquisition of more than 5% of the outstanding shares of any class of voting securities or substantially all of the assets of any bank or bank holding company. Prior FRB approval is also required for the merger or consolidation of a bank holding company with another bank holding company. Similar state banking agency approvals may also be required. Certain competitive, management, financial and other factors are considered by the bank regulatory agencies in granting these approvals.

Table of Contents

With certain exceptions, bank holding companies are prohibited from acquiring direct or indirect ownership or control of more than 5% of the outstanding voting shares of any company that is not a bank or bank holding company and from engaging directly or indirectly in activities other than those of banking, managing or controlling banks, or furnishing services to subsidiaries. However, subject to prior notice or FRB approval, bank holding companies may engage in any, or acquire shares of companies engaged in, those nonbanking activities determined by the FRB to be so closely related to banking or managing or controlling banks as to be a proper incident thereto.

It is the policy of the FRB that each bank holding company serve as a source of financial and managerial strength to its subsidiary bank or banks. A bank holding company's failure to meet its obligations to serve as a source of strength to its subsidiary banks will generally be considered by the FRB to be an unsafe and unsound banking practice or a violation of FRB regulations or both. The FRB's bank holding company rating system emphasizes risk management and evaluation of the potential impact of nondepository entities on safety and soundness.

We are also a bank holding company within the meaning of the California Financial Code. As such, the Company and its subsidiaries are subject to examination by, and may be required to file reports with, the California Department of Financial Institutions (DFI).

The Bank

As a California chartered bank, the Bank is subject to primary supervision, periodic examination, and regulation by the DFI and the Federal Deposit Insurance Corporation (FDIC), as well as certain regulations promulgated by the FRB. If, as a result of an examination, the FDIC determines that the financial condition, capital resources, asset quality, earnings prospects, management, liquidity, or other aspects of our banking operations are unsatisfactory or that we are violating or have violated any law or regulation, various remedies are available to the FDIC, including the power to enjoin unsafe or unsound practices; require affirmative action to correct any conditions resulting from any violation or practice; issue an administrative order that can be judicially enforced, to direct an increase in capital, to restrict our growth; assess civil monetary penalties; remove officers and directors; and ultimately to terminate deposit insurance, which would result in a revocation of the Bank's charter. See Safety and Soundness Standards.

The DFI also possesses broad powers to take corrective and other supervisory actions to resolve the problems of California state-chartered banks. These enforcement powers include cease and desist orders, the imposition of fines, the ability to take possession of the Bank and the ability to close and liquidate the Bank.

Changes such as the following in federal or state banking laws or the regulations, policies or guidance of the federal or state banking agencies could have an adverse cost or competitive impact on our bank operations:

(i) In December, 2006, the federal banking agencies issued final guidance to reinforce sound risk management practices for bank holding companies and banks in commercial real estate (CRE) loans which establishes CRE concentration thresholds as criteria for examiners to identify CRE concentration that may warrant further analysis. The implementation of these guidelines could result in increased reserves and capital costs for banks with CRE concentration. The Bank's CRE portfolio as of December 31, 2006 would meet the definition of CRE concentration as set forth in the guidelines. The Bank analyzes this concentration on a quarterly basis and monitors same through various reports it prepares. The Bank believes that it complies with the analytical and monitoring expectations as set forth in the aforementioned guidance. Furthermore, this concentration is considered in the methodology for the Allowance for Credit Losses.

(ii) In September, 2006, the federal banking agencies issued final guidance on alternative residential mortgage products that allow borrowers to defer repayment of principal and sometimes interest, including interest-only

mortgage loans, and payment option adjustable rate mortgages where a borrower has flexible payment options, including payments that have the potential for negative amortization. While acknowledging that innovations in mortgage lending can benefit some consumers, the final guidance states that management should (1) assess a borrower's ability to repay the loan, including any principal balances added through negative amortization, at the fully indexed rate that would apply after the introductory period, (2) recognize that certain nontraditional mortgages are untested in a stressed environment and warrant strong risk

Table of Contents

management standards as well as appropriate capital and loan loss reserves, and (3) ensure that borrowers have sufficient information to clearly understand loan terms and associated risks prior to making a product or payment choice. The Bank believes its products and disclosures are in conformance with the requirements of the guidance.

(iii) Pursuant to the Financial Services Regulatory Relief Act of 2006, the Securities and Exchange Commission (SEC) and the FRB have released, as Regulation R, joint proposed rules expected to be finalized by midyear to implement exceptions provided for in the Gramm-Leach-Bliley Act (GLBA) for bank securities activities which banks may conduct without registering with the SEC as securities brokers or moving such activities to a broker-dealer affiliate. The proposed Regulation R push out rules exceptions would allow a bank, subject to certain conditions, to continue to conduct securities transactions for customers as part of the Bank's trust and fiduciary, custodial and deposit sweep functions, and to refer customers to a securities broker-dealer pursuant to a networking arrangement with the broker-dealer. The proposed rules, if adopted, are not expected to have a material effect on the current securities activities which the Bank now conducts for customers.

Because California permits commercial banks chartered by the state to engage in any activity permissible for national banks, the Bank can form subsidiaries to engage in the many so-called closely related to banking or nonbanking activities commonly conducted by national banks in operating subsidiaries, but also expanded financial activities to the same extent as a national bank, subject to the state or FDIC requirements. However, in order to form a financial subsidiary, the Bank must be well-capitalized ; well-managed and in satisfactory compliance with the Community Reinvestment Act. Further, the Bank must exclude from its assets and equity all equity investments, including retained earnings, in a financial subsidiary. The assets of the subsidiary may not be consolidated with the Bank's assets. The Bank must also have policies and procedures to assess financial subsidiary risk and protect the Bank from such risks and potential liabilities and would be subject to the same capital deduction, risk management and affiliate transaction rules as applicable to national banks. Generally, a financial subsidiary is permitted to engage in activities that are financial in nature or incidental thereto, even though they are not permissible for the national bank to conduct directly within the Bank. The definition of financial in nature includes, among other items, underwriting, dealing in or making a market in securities, including, for example, distributing shares of mutual funds. The subsidiary may not, however, under present law engage as principal in underwriting insurance (other than credit life insurance), issue annuities or engage in real estate development or investment or merchant banking.

Interstate Banking and Branching

Subject to certain size limitations under the Riegle-Neal Interstate Banking Act, bank holding companies and banks have the ability to acquire and merge with banks in other states; and, subject to certain state restrictions, banks may also acquire or establish new branches outside their home states. Interstate branches are subject to certain laws of the states in which they are located.

The Sarbanes-Oxley Act

The Sarbanes-Oxley Act of 2002 addressed accounting oversight and corporate governance matters and, among other things,

required executive certification of financial presentations;

increased requirements for board audit committees and their members;

enhanced disclosure of controls and procedures and internal control over financial reporting;

enhanced controls on, and reporting of, insider trading; and

increased penalties for financial crimes and forfeiture of executive bonuses in certain circumstances.

The legislation and its implementing regulations have resulted in increased costs of compliance, including certain outside professional costs. To date these costs have not had a material impact on our operations.

Table of Contents***Dividends and Other Transfers of Funds***

Dividends from the Bank constitute the principal source of income to the Company. An FRB policy statement provides that a bank holding company should pay cash dividends only to the extent that the holding company's net income for the past year is sufficient to cover both the cash dividends and a rate of earnings retention that is consistent with the holding company's capital needs, asset quality and overall financial condition. The policy statement also provides that it would be inappropriate for a company experiencing serious financial problems to borrow funds to pay dividends. Furthermore, under the federal prompt corrective action regulations, the FRB may prohibit a bank holding company from paying any dividends if the holding company's bank subsidiary is classified as undercapitalized. See Prompt Corrective Action and Other Enforcement Mechanisms below.

The Bank is subject to various statutory and regulatory restrictions on its ability to pay dividends. Under such restrictions, the amount available for payment of dividends to the Company by the Bank totaled \$128.5 million at December 31, 2006. In addition, the banking agencies have the authority to prohibit the Bank from paying dividends, depending upon the Bank's financial condition, if such payment is deemed to constitute an unsafe or unsound practice.

Capital Standards

The federal banking agencies have adopted risk-based minimum capital guidelines for bank holding companies and banks which are intended to provide a measure of capital that reflects the degree of risk associated with a banking organization's operations for both transactions reported on the balance sheet as assets and transactions which are recorded as off balance sheet items. The risk-based capital ratio is determined by classifying assets and certain off-balance sheet financial instruments into weighted categories, with higher levels of capital being required for those categories perceived as representing greater risk. Under the capital guidelines, a banking organization's total capital is divided into tiers. Tier I capital consists of (1) common equity, (2) qualifying noncumulative perpetual preferred stock, (3) a limited amount of qualifying cumulative perpetual preferred stock and (4) minority interests in the equity accounts of consolidated subsidiaries (including trust-preferred securities), less goodwill and certain other intangible assets. Qualifying Tier I capital may consist of trust-preferred securities, subject to certain criteria and quantitative limits for inclusion of restricted core capital elements in Tier I capital. Tier II capital consists of hybrid capital instruments, perpetual debt, mandatory convertible debt securities, a limited amount of subordinated debt, preferred stock and trust-preferred securities that do not qualify as Tier I capital, a limited amount of the allowance for loan and lease losses and a limited amount of unrealized holding gains on equity securities. Tier III capital consists of qualifying unsecured subordinated debt. The sum of Tier II and Tier III capital may not exceed the amount of Tier I capital.

The risk-based capital guidelines require a minimum ratio of qualifying total capital to risk-adjusted assets of 8% and a minimum ratio of Tier I capital to risk-adjusted assets of 4%. In addition to the risk-based guidelines, the federal bank regulatory agencies require banking organizations to maintain a minimum amount of Tier I capital to total assets, referred to as the leverage ratio. For a banking organization rated in the highest of the five categories used by regulators to rate banking organizations, the minimum leverage ratio of Tier I capital to total assets must be 3%.

The federal banking agencies possess broad power under the Federal Deposit Insurance Act, or FDI Act, to take prompt corrective action to resolve the problems of insured depository institutions, including but not limited to those institutions that fall within any undercapitalized category. Each federal banking agency has promulgated regulations defining the following five categories in which an insured depository institution will be placed, based on its capital ratios:

well capitalized ;

adequately capitalized ;
undercapitalized ;
significantly undercapitalized ; and
critically undercapitalized.

Table of Contents

The regulations use an institution's risk-based capital, leverage capital and tangible capital ratios to determine the institution's capital classification. An institution is treated as well capitalized if its total capital to risk-weighted assets ratio is 10.00% or more; its core capital to risk-weighted assets ratio is 6.00% or more; and its core capital to adjusted total assets ratio is 5.00% or more. The regulatory capital guidelines as well as our actual capitalization on a consolidated basis and for the Bank as of December 31, 2006 are set forth below and confirm that both the Bank and the Company capital ratios exceed the minimum percentage of the federal bank regulatory agencies for being deemed well capitalized.

The following table presents the amounts of regulatory capital and the capital ratios for the Company, compared to its minimum regulatory capital requirements as of December 31, 2006:

	Actual		As of December 31, 2006 Required		Excess	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
	(Amounts in thousands)					
Leverage ratio	\$ 469,960	7.8%	\$ 240,389	4.0%	\$ 229,571	3.8%
Tier 1 risk-based ratio	\$ 469,960	12.3%	\$ 153,081	4.0%	\$ 316,879	8.3%
Total risk-based ratio	\$ 499,430	13.1%	\$ 306,164	8.0%	\$ 193,266	5.1%

The following table presents the amounts of regulatory capital and the capital ratios for the Bank, compared to its minimum regulatory capital requirements as of December 31, 2006:

	Actual		As of December 31, 2006 Required		Excess	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
	(Amounts in thousands)					
Leverage ratio	\$ 422,946	7.1%	\$ 239,969	4.0%	\$ 182,977	3.1%
Tier 1 risk-based ratio	\$ 422,946	11.1%	\$ 152,826	4.0%	\$ 270,120	7.1%
Total risk-based ratio	\$ 452,416	11.8%	\$ 305,686	8.0%	\$ 146,730	3.8%

The current risk-based capital guidelines are based upon the 1988 capital accord of the International Basel Committee on Banking Supervision. A new international accord, referred to as Basel II, which emphasizes internal assessment of credit, market and operational risk; supervisory assessment and market discipline in determining minimum capital requirements, currently becomes mandatory outside the U.S. in 2008. In October 2006, the U.S. federal banking agencies issued a notice of proposed rulemaking for comment to implement Basel II for U.S. banks with certain differences from the international Basel II framework and which would not be fully in effect for U.S. banks until 2012. Further, the U.S. banking agencies propose to retain the minimum leverage requirement and prompt corrective action regulatory standards. Additionally, in December 2006, the federal banking agencies issued another notice of proposed rulemaking for comment, referred to as Basel IA, which proposed alternative capital requirements for smaller U.S. banks which may be negatively impacted competitively by certain provisions of Basel II. At this time the impact that proposed changes in capital requirements may have on the cost and availability of different types of credit and the compliance cost of implementing Basel II or Basel IA, as applicable, are uncertain.

Safety and Soundness Standards

In addition to measures taken under the banking agencies' prompt corrective action authority and other capital guidelines, commercial banking organizations may be subject to potential enforcement actions by the federal and/or state banking agencies 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. The federal banking agencies have adopted guidelines designed to assist examiners in identifying and addressing potential safety and soundness concerns before capital becomes impaired. The guidelines set forth operational and managerial standards relating to: (i) internal controls, information systems and internal audit systems, (ii) loan documentation, (iii) credit underwriting, (iv) asset quality and growth, (v) earnings, and (vi) compensation, fees and benefits.

Table of Contents

Premiums for Deposit Insurance

Through the Bank Insurance Fund (BIF), the FDIC insures our customer deposits up to prescribed limits for each depositor. The amount of FDIC assessments paid by each BIF member institution is based on its relative risk of default as measured by regulatory capital ratios and other supervisory factors. The assessment rate currently ranges from zero to 27 cents per \$100 of domestic deposits. The FDIC may increase or decrease the assessment rate schedule on a semi-annual basis. Due principally to continued growth in deposits, the BIF is nearing its minimum ratio of 1.25% of insured deposits as mandated by law. The enactment in February 2005 of the Federal Deposit Insurance Reform Act of 2006, or FDIRA, provided, among other things, for changes in the formula and factors to be considered by the FDIC in calculating the FDIC reserve ratio, assessments and dividends, and a one-time aggregate assessment credit for depository institutions in existence on December 31, 1996 (or their successors) which paid assessments to recapitalize the insurance funds after the banking crises of the late 1980s and early 1990s. The FDIC issued final regulations, effective January 1, 2007, implementing the provisions of FDIRA. The Bank expects to receive a one-time assessment credit that is expected to exceed any increase in assessments by the FDIC in 2007.

The FDIC is authorized to terminate a depository institution's deposit insurance upon a finding by the FDIC that the institution's financial condition is unsafe or unsound or that the institution has engaged in unsafe or unsound practices or has violated any applicable rule, regulation, order or condition enacted or imposed by the institution's regulatory agency. The termination of deposit insurance for a subsidiary bank would generally have a material adverse effect on the earnings of the Bank's holding company.

All FDIC-insured depository institutions must also pay an annual assessment to provide funds for the payment of interest on bonds issued by the Financing Corporation, a federal corporation chartered under the authority of the Federal Housing Finance Board. The bonds, commonly referred to as FICO bonds, were issued to capitalize the Federal Savings and Loan Insurance Corporation. The FICO assessment rate for the fourth quarter of fiscal 2006 was 1.24 basis points for each \$100 of assessable deposits. The FICO assessments are adjusted quarterly to reflect changes in the assessment bases of the FDIC's insurance funds and do not vary depending on a depository institution's capitalization or supervisory evaluations.

Loans-to-One Borrower Limitations

With certain limited exceptions, the maximum amount of obligations, secured and unsecured, that any borrower (including certain related entities) may owe to a California state bank at any one time may not exceed 25% of the sum of the shareholders equity, allowance for loan losses, capital notes and debentures of the Bank. Unsecured obligations may not exceed 15% of the sum of the shareholders equity, allowance for loan losses, capital notes and debentures of the Bank. At December 31, 2006, the Bank's largest single lending relationship had an outstanding balance of \$27.0 million, and consisted of a loan partially secured by first trust deeds on single family residences and commercial buildings in the Bank's lending area which was performing in accordance with its terms.

Extensions of Credit to Insiders and Transactions with Affiliates

The Federal Reserve Act and FRB Regulation O place limitations and conditions on loans or extensions of credit to:

a bank's or bank holding company's executive officers, directors and principal shareholders (i.e., in most cases, those persons who own, control or have power to vote more than 10% of any class of voting securities);

any company controlled by any such executive officer, director or shareholder; or

any political or campaign committee controlled by such executive officer, director or principal shareholder.

Loans and leases extended to any of the above persons must comply with the loan-to-one-borrower limits, require prior full board approval when aggregate extensions of credit to the person exceed specified amounts, must be made on substantially the same terms (including interest rates and collateral) as, and follow credit-underwriting procedures that are not less stringent than, those prevailing at the time for comparable transactions with non-insiders, and must not involve more than the normal risk of repayment or present other unfavorable features. In addition, Regulation O provides that the aggregate limit on extensions of credit to all insiders of a bank as a group

Table of Contents

cannot exceed the Bank's unimpaired capital and unimpaired surplus. Regulation O also prohibits a bank from paying an overdraft on an account of an executive officer or director, except pursuant to a written pre-authorized interest-bearing extension of credit plan that specifies a method of repayment or a written pre-authorized transfer of funds from another account of the officer or director at the Bank.

The Bank also is subject to certain restrictions imposed by Federal Reserve Act Sections 23A and 23B and FRB Regulation W on any extensions of credit to, or the issuance of a guarantee or letter of credit on behalf of, any affiliates, the purchase of, or investments in, stock or other securities thereof, the taking of such securities as collateral for loans, and the purchase of assets of any affiliates. Such restrictions prevent any affiliates from borrowing from the Bank unless the loans are secured by marketable obligations of designated amounts. Further, such secured loans and investments to or in any affiliate are limited, individually, to 10.0% of the Bank's capital and surplus (as defined by federal regulations), and such secured loans and investments are limited, in the aggregate, to 20.0% of capital and surplus. Some of the entities included in the definition of an affiliate are parent companies, sister banks, sponsored and advised companies, investment companies whereby the Bank's affiliate serves as investment advisor, and financial subsidiaries. Additional restrictions on transactions with affiliates may be imposed under the FDI Act prompt corrective action provisions and the supervisory authority of the federal and state banking agencies. See Capital Standards and Safety and Soundness Standards.

USA Patriot Act

The USA PATRIOT Act of 2001 and its implementing regulations significantly expanded the anti-money laundering and financial transparency laws. Under the USA PATRIOT Act, financial institutions are required to establish and maintain anti-money laundering programs which include:

- the establishment of a customer identification program;
- the development of internal policies, procedures, and controls;
- the designation of a compliance officer;
- an ongoing employee training program; and
- an independent audit function to test the programs.

We have adopted comprehensive policies and procedures to address the requirements of the USA PATRIOT Act. Material deficiencies in anti-money laundering compliance can result in public enforcement actions by the banking agencies, including the imposition of civil money penalties and supervisory restrictions on growth and expansion. Such enforcement actions could also have serious reputation consequences for the Company and the Bank.

Consumer Protection Laws and Regulations

Examination and enforcement by the state and federal banking agencies for non-compliance with consumer protection laws and their implementing regulations have become more intense. The Bank is subject to many federal consumer protection statutes and regulations, some of which are discussed below.

The Home Ownership and Equal Protection Act of 1994, or HOEPA, requires extra disclosures and consumer protections to borrowers for certain lending practices. The term predatory lending, much like the terms safety and soundness and unfair and deceptive practices, is far-reaching and covers a potentially broad range of behavior. As such, it does not lend itself to a concise or a comprehensive definition. Typically predatory lending involves at least

one, and perhaps all three, of the following elements:

making unaffordable loans based on the assets of the borrower rather than on the borrower's ability to repay an obligation (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 (loan flipping); and/or

engaging in fraud or deception to conceal the true nature of the loan obligation from an unsuspecting or unsophisticated borrower.

Table of Contents

Federal Reserve regulations and OCC guidelines aimed at curbing predatory lending significantly widen the pool of high cost home secured loans covered by HOEPA. In addition, the regulations bar certain refinances within a year with another loan subject to HOEPA by the same lender or loan servicer. Lenders also will be presumed to have violated the law which says loans should not 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. We do not expect these rules and potential state action in this area to have a material impact on our financial condition or results of operation.

Privacy policies are required by federal banking regulations which limit the ability of banks and other financial institutions to disclose non-public information about consumers to nonaffiliated third parties. Pursuant to those rules, financial institutions must provide:

- initial notices to customers about their privacy policies, describing the conditions under which they may disclose nonpublic personal information to nonaffiliated third parties and affiliates;

- annual notices of their privacy policies to current customers; and

- a reasonable method for customers to opt out of disclosures to nonaffiliated third parties.

These privacy protections affect how consumer information is transmitted through diversified financial companies and conveyed to outside vendors. In addition, state laws may impose more restrictive limitations on the ability of financial institution to disclose such information. California has adopted such a privacy law that among other things generally provides that customers must opt in before information may be disclosed to certain nonaffiliated third parties.

The Fair Credit Reporting Act, as amended by the Fair and Accurate Credit Transactions Act, or FACT Act, requires financial firms to help deter identity theft, including developing appropriate fraud response programs, and gives consumers more control of their credit data. It also reauthorizes a federal ban on state laws that interfere with corporate credit granting and marketing practices. In connection with FACT Act, the federal financial institution regulatory agencies proposed rules that would prohibit an institution from using certain information about a consumer it received from an affiliate to make a solicitation to the consumer, unless the consumer has been notified and given a chance to opt out of such solicitations. A consumer’