CVB FINANCIAL CORP
Form 10-Q
August 09, 2010
FORM 10-Q
UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D. C. 20549

## p QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended June 30, 2010
or

- TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from $\qquad$ to
Commission File Number: 0-10140 CVB FINANCIAL CORP.
(Exact name of registrant as specified in its charter)

California<br>(State or other jurisdiction of incorporation or organization)<br>95-3629339<br>(I.R.S. Employer Identification No.) 91764<br>(Zip Code)<br>701 North Haven Ave, Suite 350, Ontario, California<br>(Address of Principal Executive Offices)<br>(Registrant s telephone number, including area code) (909) 980-4030

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 p No o 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). Yes o No o
Indicate by check mark whether the registrant is a large accelerated filer, accelerated filer, non-accelerated filer or smaller reporting company. See definition of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer o Accelerated filer p Non-accelerated filer o Smaller reporting company o Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No p
Number of shares of common stock of the registrant: 106,435,754 outstanding as of August 4, 2010.

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## PART I FINANCIAL INFORMATION (UNAUDITED) <br> ITEM 1. FINANCIAL STATEMENTS <br> CVB FINANCIAL CORP. AND SUBSIDIARIES CONSOLIDATED BALANCE SHEETS (unaudited) <br> Dollar amounts in thousands

| ASSETS | June 30, 2010 | $\begin{gathered} \text { December 31, } \\ 2009 \end{gathered}$ |  |
| :---: | :---: | :---: | :---: |
|  |  |  |  |
| Cash and due from banks | \$ 451,236 | \$ | 103,254 |
| Interest-bearing balances due from depository institutions | 50,274 |  | 1,226 |
| Total cash and cash equivalents | 501,510 |  | 104,480 |
| Investment in stock of Federal Home Loan Bank (FHLB) | 93,962 |  | 97,582 |
| Investment securities available-for-sale | 2,011,492 |  | 2,108,463 |
| Investment securities held-to-maturity | 3,173 |  | 3,838 |
| Loans held-for-sale | 2,554 |  | 1,439 |
| Loans and lease finance receivables | 3,929,321 |  | 4,079,013 |
| Allowance for credit losses | $(118,548)$ |  | $(108,924)$ |
| Net Loans and lease finance receivables | 3,810,773 |  | 3,970,089 |
| Premises and equipment, net | 42,585 |  | 41,444 |
| Bank owned life insurance | 111,385 |  | 109,480 |
| Accrued interest receivable | 26,967 |  | 28,672 |
| Intangibles | 10,872 |  | 12,761 |
| Goodwill | 55,097 |  | 55,097 |
| FDIC loss sharing asset | 111,992 |  | 133,258 |
| Other assets | 78,034 |  | 73,166 |
| TOTAL ASSETS | \$ 6,860,396 | \$ | 6,739,769 |
| LIABILITIES AND STOCKHOLDERS EQUITY |  |  |  |
| Liabilities: |  |  |  |
| Deposits: |  |  |  |
| Noninterest-bearing | \$ 1,646,717 | \$ | 1,561,981 |
| Interest-bearing | 2,954,773 |  | 2,876,673 |
| Total deposits | 4,601,490 |  | 4,438,654 |
| Demand Note to U.S. Treasury | 2,611 |  | 2,425 |
| Repurchase agreements | 745,661 |  | 735,132 |
| Borrowings | 653,254 |  | 753,118 |
| Accrued interest payable | 5,818 |  | 6,481 |


| Deferred compensation | 9,281 | 9,166 |
| :--- | ---: | ---: |
| Junior subordinated debentures | 115,055 | 115,055 |
| Other liabilities | 53,242 | 41,510 |
| TOTAL LIABILITIES | $6,186,412$ | $6,101,541$ |
|  |  |  |
| COMMITMENTS AND CONTINGENCIES |  |  |
| Stockholders Equity: | 493,393 | 491,226 |
| Preferred stock, authorized, 20,000,000 shares without par; none issued or | 42,670 | 120,612 |
| outstanding | 42,921 | 26,390 |
| Common stock, authorized, 225,000,000 shares without par; issued and | 673,984 | 638,228 |
| outstanding 106,435,754 (2010) and 106,263,511 (2009) |  |  |
| Retained earnings | $\$, 860,396$ | $\$$ |
| Accumulated other comprehensive income, net of tax | $6,739,769$ |  |

See accompanying notes to the consolidated financial statements.

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## CVB FINANCIAL CORP. AND SUBSIDIARIES CONSOLIDATED STATEMENTS OF EARNINGS (unaudited) <br> Dollar amounts in thousands, except per share

|  | For the Three Months Ended June 30, |  |  |  | For the Six Months Ended June 30, |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  | 2010 |  | 2009 |  | 2010 |  | 2009 |  |
| Interest income: |  |  |  |  |  |  |  |  |
| Loans, including fees | \$ | 59,172 | \$ | 49,771 | \$ | 126,940 | \$ | 99,296 |
| Investment securities: |  |  |  |  |  |  |  |  |
| Taxable |  | 14,391 |  | 19,134 |  | 30,475 |  | 41,570 |
| Tax-preferred |  | 6,409 |  | 6,815 |  | 12,941 |  | 13,811 |
| Total investment income |  | 20,800 |  | 25,949 |  | 43,416 |  | 55,381 |
| Dividends from FHLB stock |  | 63 |  |  |  | 129 |  |  |
| Federal funds sold and Interest bearing deposits with other institutions |  | 238 |  | 55 |  | 340 |  | 59 |
| Total interest income |  | 80,273 |  | 75,775 |  | 170,825 |  | 154,736 |
| Interest expense: |  |  |  |  |  |  |  |  |
| Deposits |  | 4,841 |  | 6,439 |  | 10,129 |  | 13,029 |
| Borrowings |  | 10,390 |  | 14,212 |  | 21,510 |  | 30,102 |
| Junior subordinated debentures |  | 828 |  | 1,029 |  | 1,633 |  | 2,219 |
| Total interest expense |  | 16,059 |  | 21,680 |  | 33,272 |  | 45,350 |
| Net interest income before provision for credit |  |  |  |  |  |  |  |  |
| losses |  | 64,214 |  | 54,095 |  | 137,553 |  | 109,386 |
| Provision for credit losses |  | 11,000 |  | 20,000 |  | 23,200 |  | 42,000 |
| Net interest income after provision for credit losses |  | 53,214 |  | 34,095 |  | 114,353 |  | 67,386 |
| Other operating income: |  |  |  |  |  |  |  |  |
| Impairment loss on investment securities |  |  |  |  |  | (98) |  |  |
| Plus: Reclassification of credit-related impairment |  |  |  |  |  |  |  |  |
| loss from other comprehensive income |  |  |  |  |  | (587) |  |  |
| Net impairment loss on investment securities recognized in earnings |  |  |  |  |  | (685) |  |  |
| Service charges on deposit accounts |  | 4,196 |  | 3,643 |  | 8,461 |  | 7,360 |
| Trust and Investment Services |  | 2,209 |  | 1,604 |  | 4,327 |  | 3,265 |
| Bankcard services |  | 711 |  | 586 |  | 1,350 |  | 1,120 |
| BOLI income |  | 737 |  | 659 |  | 1,581 |  | 1,396 |
| Reduction in FDIC loss sharing asset |  | $(1,587)$ |  |  |  | $(12,170)$ |  |  |
| Other |  | 371 |  | 598 |  | 1,562 |  | 1,377 |
| Gain on sale of securities |  | 8,781 |  | 12,619 |  | 8,781 |  | 21,548 |
| Total other operating income |  | 15,418 |  | 19,709 |  | 13,207 |  | 36,066 |


| Other operating expenses: |  |  |  |  |  |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Salaries and employee benefits |  | 17,479 |  | 15,376 |  | 35,552 |  | 31,196 |
| Occupancy and Equipment |  | 4,782 |  | 4,421 |  | 9,835 |  | 8,870 |
| Professional services |  | 2,881 |  | 1,658 |  | 5,688 |  | 3,352 |
| Amortization of intangibles |  | 939 |  | 734 |  | 1,889 |  | 1,523 |
| Other |  | 15,366 |  | 10,790 |  | 24,405 |  | 19,435 |
| Total other operating expenses |  | 41,447 |  | 32,979 |  | 77,369 |  | 64,376 |
| Earnings before income taxes |  | 27,185 |  | 20,825 |  | 50,191 |  | 39,076 |
| Income taxes |  | 8,170 |  | 4,964 |  | 15,057 |  | 10,048 |
| Net earnings | \$ | 19,015 | \$ | 15,861 | \$ | 35,134 | \$ | 29,028 |
| Preferred stock dividend and other reductions |  | 64 |  | 2,000 |  | 119 |  | 3,993 |
| Net earnings allocated to common shareholders | \$ | 18,951 | \$ | 13,861 | \$ | 35,015 | \$ | 25,035 |
| Comprehensive income | \$ | 28,812 | \$ | 5,329 | \$ | 51,665 | \$ | 24,771 |
| Basic earnings per common share | \$ | 0.18 | \$ | 0.17 | \$ | 0.33 | \$ | 0.30 |
| Diluted earnings per common share | \$ | 0.18 | \$ | 0.17 | \$ | 0.33 | \$ | 0.30 |
| Cash dividends per common share | \$ | 0.085 | \$ | 0.085 | \$ | 0.17 | \$ | 0.17 |

See accompanying notes to the consolidated financial statements.

## CVB FINANCIAL CORP. AND SUBSIDIARIES CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY AND COMPREHENSIVE INCOME <br> (Unaudited) <br> Amounts and shares in thousands



Stock-based
Compensation
Expense
Amortization of
preferred stock
discount 711
(711)

Cash dividends (\$0.17
per share)
Preferred $\quad(3,250) \quad(3,250)$
Common $\quad(14,162)$
Comprehensive
income:
Net earnings $\quad 29,028 \quad \$ \quad 29,028 \quad 29,028$
Other comprehensive
loss:
Unrealized loss on securities
available-for-sale, net
Comprehensive
income \$ 24,771
Balance June 30,
$2009 \quad 83,326 \quad \$ 122,219 \quad \$ 365,594 \quad \$ 111,089 \quad \$ \quad 24,474 \quad \$ 623,376$
At June 30,
2010

## Disclosure of reclassification amount

Unrealized gain/(loss) on securities arising during the period
Tax (benefit)/expense
Net unrealized gain/(loss) on securities

| $\$$ | 28,501 | $\$$ | $(7,339)$ |
| :---: | :---: | :---: | :---: |
|  | $(11,970)$ |  | 3,082 |

See accompanying notes to the consolidated financial statements.

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## CVB FINANCIAL CORP. AND SUBSIDIARIES CONSOLIDATED STATEMENTS OF CASH FLOWS (unaudited) Dollar amounts in thousands

|  |  | For the Six Months Ended June 30, |  |  |
| :---: | :---: | :---: | :---: | :---: |
|  | 2010 |  | 2009 |  |
| CASH FLOWS FROM OPERATING ACTIVITIES: |  |  |  |  |
| Interest and dividends received | \$ | 156,010 | \$ | 155,769 |
| Service charges and other fees received |  | 15,668 |  | 14,494 |
| Interest paid |  | $(34,043)$ |  | $(46,533)$ |
| Cash paid to vendors and employees |  | $(54,566)$ |  | $(59,257)$ |
| Income taxes paid |  | $(18,522)$ |  | $(23,386)$ |
| Net cash provided by operating activities |  | 64,547 |  | 41,087 |
| CASH FLOWS FROM INVESTING ACTIVITIES: |  |  |  |  |
| Proceeds from sale of FHLB Stock |  | 3,621 |  |  |
| Proceeds from sales of investment securities |  | 173,607 |  | 440,343 |
| Proceeds from repayment of investment securities |  | 142,689 |  | 210,361 |
| Proceeds from maturity of investment securities |  | 54,509 |  | 46,417 |
| Purchases of investment securities |  | $(238,172)$ |  | $(462,387)$ |
| Net decrease in loans and lease finance receivables |  | 136,401 |  | 95,787 |
| Proceeds from sales of premises and equipment |  | 87 |  | 216 |
| Proceeds from sales of other real estate owned |  | 7,901 |  | 9,413 |
| Purchase of premises and equipment |  | $(4,611)$ |  | $(2,172)$ |
| Other, net |  | (330) |  | (375) |
| Net cash provided by investing activities |  | 275,702 |  | 337,603 |
| CASH FLOWS FROM FINANCING ACTIVITIES: |  |  |  |  |
| Net increase in transaction deposits |  | 157,890 |  | 276,273 |
| Net increase in time deposits |  | 5,190 |  | 198,791 |
| Repayment of advances from Federal Home Loan Bank |  | $(100,000)$ |  | $(600,000)$ |
| Net increase/(decrease) in other borrowings |  | 186 |  | $(179,037)$ |
| Net increase in repurchase agreements |  | 10,529 |  | 68,298 |
| Cash dividends on preferred stock |  |  |  | $(3,250)$ |
| Cash dividends on common stock |  | $(18,076)$ |  | $(14,162)$ |
| Proceeds from exercise of stock options |  | 725 |  | 280 |
| Tax benefit related to exercise of stock options |  | 337 |  | 62 |
| Net cash (used in)/provided by financing activities |  | 56,781 |  | $(252,745)$ |
| NET INCREASE IN CASH AND CASH EQUIVALENTS |  | 397,030 |  | 125,945 |
| CASH AND CASH EQUIVALENTS, beginning of period |  | 104,480 |  | 95,297 |
| CASH AND CASH EQUIVALENTS, end of period | \$ | 501,510 | \$ | 221,242 |

See accompanying notes to the consolidated financial statements.

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## CVB FINANCIAL CORP. AND SUBSIDIARIES CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued) (unaudited) <br> Dollar amounts in thousands

|  | For the Six Months Ended June 30, |  |  |  |
| :---: | :---: | :---: | :---: | :---: |
|  |  | 2010 |  | 2009 |
| RECONCILIATION OF NET EARNINGS TO NET CASH PROVIDED BY OPERATING ACTIVITIES: |  |  |  |  |
| Net earnings | \$ | 35,134 | \$ | 29,028 |
| Adjustments to reconcile net earnings to net cash provided by operating activities: |  |  |  |  |
| Gain on sale of investment securities |  | $(8,781)$ |  | $(21,548)$ |
| Loss on sale of premises and equipment |  | 65 |  | 57 |
| Loss on sale of other real estate owned |  | (910) |  |  |
| Increase from bank owned life insurance |  | $(1,581)$ |  | $(1,396)$ |
| Net amortization of premiums on investment securities |  | 2,357 |  | 579 |
| Accretion of SJB Discount |  | $(17,852)$ |  |  |
| Provisions for credit losses |  | 23,200 |  | 42,000 |
| Reduction in FDIC Loss Sharing Asset |  | 12,170 |  |  |
| Stock-based compensation |  | 1,105 |  | 783 |
| Depreciation and amortization |  | 5,206 |  | 5,002 |
| Change in accrued interest receivable |  | 1,705 |  | 2,199 |
| Change in accrued interest payable |  | (663) |  | $(1,182)$ |
| Change in other assets and liabilities |  | 13,392 |  | $(14,435)$ |
| Total adjustments |  | 29,413 |  | 12,059 |
| NET CASH PROVIDED BY OPERATING ACTIVITIES | \$ | 64,547 | \$ | 41,087 |
| SUPPLEMENTAL DISCLOSURE OF NONCASH INVESTING ACTIVITIES |  |  |  |  |
|  |  |  |  |  |
| Transfer from loans to Other Real Estate Owned | \$ | 18,227 | \$ | 7,644 |
| See accompanying notes to the consolidated financial statements. |  |  |  |  |

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# CVB FINANCIAL CORP. AND SUBSIDIARIES <br> NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS 

(unaudited)
For the six months ended June 30, 2010 and 2009

## 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The accompanying condensed consolidated unaudited financial statements and notes thereto have been prepared in accordance with the rules and regulations of the Securities and Exchange Commission for Form 10-Q and conform to practices within the banking industry and include all of the information and disclosures required by accounting principles generally accepted in the United States of America for interim financial reporting. The results of operations for the six months ended June 30, 2010 are not necessarily indicative of the results for the full year. These financial statements should be read in conjunction with the financial statements, accounting policies and financial notes thereto included in the Company s Annual Report on Form 10-K for the fiscal year ended December 31, 2009 filed with the Securities and Exchange Commission. In the opinion of management, the accompanying condensed consolidated unaudited financial statements reflect all adjustments (consisting only of normal recurring adjustments), which are necessary for a fair presentation of financial results for the interim periods presented. A summary of the significant accounting policies consistently applied in the preparation of the accompanying consolidated financial statements follows.
Principles of Consolidation - The consolidated financial statements include the accounts of CVB Financial Corp. (the Company ) and its wholly owned subsidiary: Citizens Business Bank (the Bank ) after elimination of all intercompany transactions and balances. The Company also has three inactive subsidiaries: CVB Ventures, Inc.; Chino Valley Bancorp; and Orange National Bancorp. The Company is also the common stockholder of CVB Statutory Trust I, CVB Statutory Trust II, CVB Statutory Trust III and FCB Trust II. 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. The Company acquired FCB Trust II through the acquisition of First Coastal Bancshares ( FCB ). These trusts do not meet the criteria for consolidation.
Nature of Operations - The Company s primary operations are related to traditional banking activities, including the acceptance of deposits and the lending and investing of money through the operations of the Bank. The Bank also provides automobile and equipment leasing to customers through its Citizens Financial Services Division and trust and investment-related services to customers through its CitizensTrust Division. The Bank s customers consist primarily of small to mid-sized businesses and individuals located in San Bernardino County, Riverside County, Orange County, Los Angeles County, Madera County, Fresno County, Tulare County, Kern County and San Joaquin County. The Bank operates 44 Business Financial Centers, 6 Commercial Banking Centers, and three wealth management offices with its headquarters located in the city of Ontario.
The Company s operating business units have been divided into two main segments: (i) Business Financial and Commercial Banking Centers and (ii) Treasury. Business Financial and Commercial Banking Centers (branches) are comprised of loans, deposits, and products and services the Bank offers to the majority of its customers. The other segment is Treasury, which manages the investment portfolio of the Company. The Company s remaining centralized functions and eliminations of inter-segment amounts have been aggregated and included in Other.
The internal reporting of the Company considers all business units. Funds are allocated to each business unit based on its need to fund assets (use of funds) or its need to invest funds (source of funds). Net income is determined based on the actual net income of the business unit plus the allocated income or expense based on the sources and uses of funds for each business unit. Non-interest income and non-interest expense are those items directly attributable to a business unit.

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Cash and due from banks - Cash on hand, cash items in the process of collection, and amounts due from correspondent banks and the Federal Reserve Bank are included in Cash and due from banks.
Investment Securities - The Company classifies as held-to-maturity those debt securities that the Company has the positive intent and ability to hold to maturity. Securities classified as trading are those securities that are bought and held principally for the purpose of selling them in the near term. All other debt and equity securities are classified as available-for-sale. Securities held-to-maturity are accounted for at cost and adjusted for amortization of premiums and accretion of discounts. Trading securities are accounted for at fair value with the unrealized gains and losses being included in current earnings. Available-for-sale securities are accounted for at fair value, with the net unrealized gains and losses, net of income tax effects, presented as a separate component of stockholders equity. Realized gains and losses on sales of securities are recognized in earnings at the time of sale and are determined on a specific-identification basis. Purchase premiums and discounts are recognized in interest income using the effective-yield method over the terms of the securities. For mortgage-backed securities ( MBS ), the amortization or accretion is based on estimated average lives of the securities. The lives of these securities can fluctuate based on the amount of prepayments received on the underlying collateral of the securities. The Company $s$ investment in Federal Home Loan Bank ( FHLB ) stock is carried at cost.
At each reporting date, securities are assessed to determine whether there is an other-than-temporary impairment. Other-than-temporary impairment on investment securities is recognized in earnings when there are credit losses on a debt security for which management does not intend to sell and for which it is more-likely-than-not that the Company will not have to sell prior to recovery of the noncredit impairment. In those situations, the portion of the total impairment that is attributable to the credit loss would be recognized in earnings, and the remaining difference between the debt security s amortized cost and its fair value would be included in other comprehensive income.
Loans and Lease Finance Receivables - Loans and lease finance receivables are reported at the principal amount outstanding, less deferred net loan origination fees. Interest on loans and lease finance receivables is credited to income based on the principal amount outstanding. Interest income is not recognized on loans and lease finance receivables when collection of interest is deemed by management to be doubtful. In the ordinary course of business, the Company enters into commitments to extend credit to its customers. These commitments are not reflected in the accompanying consolidated financial statements. As of June 30, 2010, the Company had entered into commitments with certain customers amounting to $\$ 573.3$ million compared to $\$ 596.6$ million at December 31, 2009. Letters of credit at June 30, 2010 and December 31, 2009, were $\$ 68.3$ million and $\$ 69.5$ million, respectively.
The Bank receives collateral to support loans, lease finance receivables, and commitments to extend credit for which collateral is deemed necessary. The most significant categories of collateral are real estate, principally commercial and industrial income-producing properties, real estate mortgages, and assets utilized in agribusiness.
Nonrefundable fees and direct costs associated with the origination or purchase of loans are deferred and netted against outstanding loan balances. The deferred net loan fees and costs are recognized in interest income over the loan term using the effective-yield method.
Acquired loans for which there is deterioration in credit quality between origination and acquisition of the loans and the bank does not expect to collect all amounts due according to the loan s contractual terms are accounted for individually or in pools of loans based on common risk characteristics. These loans are within the scope of accounting guidance for loans acquired with deteriorated credit quality. The excess of the loan s or pool s scheduled contractual principal and interest payments over all cash flows expected at acquisition is the nonaccretable difference. The remaining amount, representing the excess of the loan s cash flows expected to be collected over the fair value is the accretable yield (accreted into interest income over the remaining life of the loan or pool). The Bank has also elected to account for acquired loans not within the scope of accounting guidance using this same methodology.

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Provision and Allowance for Credit Losses - The determination of the balance in the allowance for credit losses is based on an analysis of the loan and lease finance receivables portfolio using a systematic methodology and reflects an amount that, in management s judgment, is adequate to provide for probable credit losses inherent in the portfolio, after giving consideration to the character of the loan portfolio, current economic conditions, past credit loss experience, and such other factors that would deserve current recognition in estimating inherent credit losses. The estimate is reviewed quarterly by the Board of Directors and management and periodically by various regulatory entities and, as adjustments become necessary, they are reported in earnings in the periods in which they become known. The provision for credit losses is charged to expense. During the first six months of 2010, we recorded a provision for credit losses of $\$ 23.2$ million. The allowance for credit losses was $\$ 118.5$ million as of June 30,2010 , or $3.38 \%$ of total non-covered loans and leases.
In addition to the allowance for credit losses, the Company also has a reserve for undisbursed commitments for loans and letters of credit. This reserve is carried in the liabilities section of the balance sheet in other liabilities. Provisions to this reserve are included in other expense. For the first six months of 2010, the Company recorded an increase of $\$ 1,700,000$ in the reserve for undisbursed commitments. As of June 30, 2010, the balance in this reserve was $\$ 9.6$ million.
A loan for which collection of principal and interest according to its original terms is not probable is considered to be impaired. The Company s policy is to record a specific valuation allowance, which is included in the allowance for credit losses, or charge off that portion of an impaired loan that exceeds its fair value less selling costs. Fair value is usually based on the value of underlying collateral.
At June 30, 2010, the Company had non-covered impaired loans of $\$ 86.5$ million. Of this amount, $\$ 2.8$ million consisted of non-accrual residential construction and land loans, $\$ 39.1$ million in non-accrual commercial construction loans, $\$ 12.7$ million of non-accrual single family mortgage loans, $\$ 20.7$ million of non-accrual commercial real estate loans, $\$ 7.5$ million of non-accrual commercial and industrial loans, and $\$ 143,000$ of non-accrual consumer loans. Non-covered impaired loans also include $\$ 24.2$ million of loans whose terms were modified in a troubled debt restructure, of which $\$ 20.6$ million are classified as non-accrual. The remaining balance of $\$ 3.6$ million consists of three loans performing according to the restructured terms. The non-covered impaired loans of $\$ 86.5$ million, net of $\$ 7.5$ million in charge-offs, are supported by collateral with a fair value less selling costs and net of prior liens. For the collateral-deficient loans, the amount of specific reserve was $\$ 807,000$ at June 30, 2010. At December 31, 2009, the Bank had classified as impaired, non-covered loans with a balance of $\$ 72.3$ million.
Premises and Equipment - Premises and equipment are stated at cost, less accumulated depreciation, which is provided for in amounts sufficient to relate the cost of depreciable assets to operations over their estimated service lives using the straight-line method. Properties under capital lease and leasehold improvements are amortized over the shorter of estimated economic lives of 15 years or the initial terms of the leases. Estimated lives are 3 to 5 years for computer and equipment, 5 to 7 years for furniture, fixtures and equipment, and 15 to 40 years for buildings and improvements. Long-lived assets are reviewed periodically for impairment when events or changes in circumstances indicate that the carrying amount may not be recoverable. The existence of impairment is based on undiscounted cash flows. To the extent impairment exists, the impairment is calculated as the difference in fair value of assets and their carrying value. The impairment loss, if any, would be recorded in noninterest expense.
FDIC Loss Sharing Asset - The FDIC loss sharing asset is initially recorded at fair value which represents the present value of the estimated cash payments from the FDIC for future losses on covered loans. The ultimate collectability of this asset is dependent upon the performance of the underlying covered loans, the passage of time and claims paid by the FDIC.

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Other Real Estate Owned - Other real estate owned ( OREO ) represents real estate acquired through foreclosure in satisfaction of commercial and real estate loans and is stated at fair value, minus estimated costs to sell (fair value at time of foreclosure). Loan balances in excess of fair value of the real estate acquired at the date of acquisition are charged against the allowance for credit losses. Any subsequent operating expenses or income, reduction in estimated values, and gains or losses on disposition of such properties are charged to current operations. OREO is recorded in other assets on the consolidated balance sheets.
Business Combinations and Intangible Assets - The Company has engaged in the acquisition of financial institutions and the assumption of deposits and purchase of assets from other financial institutions in its market area. The Company has paid premiums on certain transactions, and such premiums are recorded as intangible assets, in the form of goodwill or other intangible assets. Goodwill is not being amortized whereas identifiable intangible assets with finite lives are amortized over their useful lives. On an annual basis, the Company tests goodwill and intangible assets for impairment.
At June 30, 2010 goodwill was $\$ 55.1$ million. As of June 30, 2010, intangible assets that continue to be subject to amortization include core deposit premiums of $\$ 10.9$ million (net of $\$ 21.1$ million of accumulated amortization). Amortization expense for such intangible assets was $\$ 1.9$ million for the six months ended June 30, 2010. Estimated amortization expense, for the remainder of 2010 is expected to be $\$ 1.8$ million. Estimated amortization expense, for the succeeding five fiscal years is $\$ 3.5$ million for year one, $\$ 2.2$ million for year two, $\$ 1.1$ million for year three, $\$ 475,000$ for year four and $\$ 1.8$ million thereafter. The weighted average remaining life of intangible assets is approximately 3.6 years.
Bank Owned Life Insurance - The Bank invests in Bank-Owned Life Insurance ( BOLI ). BOLI involves the purchasing of life insurance by the Bank on a select group of employees. The Bank is the owner and beneficiary of these policies. BOLI is recorded as an asset at cash surrender value. Increases in the cash value of these policies, as well as insurance proceeds received, are recorded in other non-interest income and are not subject to income tax.
Income Taxes - Income taxes are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases and operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. Future realization of deferred tax assets ultimately depends on the existence of sufficient taxable income of the appropriate character (for example, ordinary income or capital gain) within the carryback or carryforward periods available under the tax law. Based on historical and future expected taxable earnings and available strategies, the Company considers the future realization of these deferred tax assets more likely than not.
The tax effects from an uncertain tax position are recognized in the financial statements only if, based on its merits, the position is more likely than not to be sustained on audit by the taxing authorities. Interest and penalties related to uncertain tax positions are recorded as part of other operating expense.
Earnings per Common Share - The Company calculates earnings per common share ( EPS ) using the two-class method. The two-class method requires the Company to present EPS as if all of the earnings for the period are distributed to common shareholders and any participating securities, regardless of whether any actual dividends or distributions are made. All outstanding unvested share-based payment awards that contain rights to non-forfeitable dividends are considered participating securities. The Company grants restricted shares under the 2008 Equity Incentive Plan that qualify as participating securities. Restricted shares issued under this plan are entitled to dividends at the same rate as common stock.

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Basic earnings per common share are computed by dividing income allocated to common stockholders by the weighted-average number of common shares outstanding during each period. The computation of diluted earnings per common share considers the number of tax-effected shares issuable upon the assumed exercise of outstanding common stock options. Share and per share amounts have been retroactively restated to give effect to all stock dividends and splits. The number of shares outstanding at June 30, 2010 was 106,435,754. The tables below presents the reconciliation of earnings per share for the periods indicated.

## Earnings Per Share Reconciliation

(Dollars and shares in thousands, except per share amounts)

|  | For the six months ended June 30, |  |  |  | For the three months ended June 30, |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  | 2010 |  | 2009 |  | 2010 |  | 2009 |  |
| Earnings per common share |  |  |  |  |  |  |  |  |
| Net earnings | \$ | 35,134 | \$ | 29,028 | \$ | 19,015 | \$ | 15,861 |
| Less: Dividends on preferred stock and discount amortization |  |  |  | 3,961 |  |  |  | 1,983 |
| Net earnings available to common shareholders | \$ | 35,134 | \$ | 25,067 | \$ | 19,015 | \$ | 13,878 |
| Less: Net earnings allocated to restricted stock |  | 119 |  | 32 |  | 64 |  | 17 |

Net earnings allocated to common shareholders (numerator)

Weighted Average Shares Outstanding (denominator)
Earnings per common share

## Diluted earnings per common share

Net income allocated to common shareholders (numerator)

Weighted Average Shares Outstanding Incremental shares from assumed exercise of outstanding options

Diluted Weighted Average Shares Outstanding (denominator)
Diluted earnings per common share

Stock-Based Compensation - At June 30, 2010, the Company has three stock-based employee compensation plans, which are described more fully in Note 16 in the Company s Annual Report on Form 10-K. The Company accounts for stock compensation using the modified prospective method. Under this method, awards that are granted, modified, or settled after December 31, 2005, are fair valued as of grant date and compensation costs recognized over the vesting period on a straight-lined basis. Also under this method, unvested stock awards as of January 1, 2006 are recognized over the remaining service period with no change in historical reported earnings.

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Derivative Financial Instruments - All derivative instruments, including certain derivative instruments embedded in other contracts, are recognized on the consolidated balance sheet at fair value. For derivatives designated as fair value hedges, changes in the fair value of the derivative and the hedged item related to the hedged risk are recognized in earnings. Changes in fair value of derivatives designated and accounted for as cash flow hedges, to the extent they are effective as hedges, are recorded in Other Comprehensive Income, net of deferred taxes and are subsequently reclassified to earnings when the hedged transaction affects earnings. Any hedge ineffectiveness would be recognized in the income statement line item pertaining to the hedged item.
Statement of Cash Flows - Cash and cash equivalents as reported in the statements of cash flows include cash and due from banks. Cash flows from loans and deposits are reported net.
CitizensTrust - This division provides trust, investment and brokerage related services, as well as financial, estate and business succession planning services. CitizensTrust services its clients through three offices in Southern California: Pasadena, Ontario, and Irvine. CitizensTrust has approximately $\$ 2.0$ billion in assets under administration, including $\$ 1.1$ billion in assets under management. The amount of these funds and the related liability have not been recorded in the accompanying consolidated balance sheets because they are not assets or liabilities of the Bank or Company, with the exception of any funds held on deposit with the Bank.

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Use of Estimates in the Preparation of Financial Statements - The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. A material estimate that is particularly susceptible to significant change in the near term relates to the determination of the allowance for credit losses. Other significant estimates which may be subject to change include fair value disclosures, impairment of investments and goodwill, and valuation of deferred tax assets, other intangibles and OREO.
Recent Accounting Pronouncements - In July 2010, the FASB issued an accounting standards update (ASU) 2010-20, Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses, which amends FASB ASC Topic 310, Receivables. The update will significantly increase disclosures that entities must make about the credit quality of financing receivables and the allowance for credit losses. The disclosures will provide financial statement users with additional information about the nature of credit risks inherent in entities financing receivables, how credit risk is analyzed and assessed when determining the allowance for credit losses, and the reasons for the change in the allowance for credit losses. The guidance in the ASU is effective for interim and annual reporting periods beginning after December 15, 2010. The Company does not expect the adoption of ASU 2010-20 to have a material effect on the Company s consolidated financial position or results of operations.
Shareholder Rights Plan - The Company had a shareholder rights plan designed to maximize long-term value and to protect shareholders from improper takeover tactics and takeover bids which are not fair to all shareholders. In accordance with the plan, preferred share purchase rights were distributed as a dividend at the rate of one right to purchase one one-thousandth of a share of the Company s Series A Participating Preferred Stock at an initial exercise price of $\$ 50.00$ (subject to adjustment as described in the terms of the plan) upon the occurrence of certain triggering events. The shareholder rights plan expired pursuant to its terms on June 21, 2010.
Other Contingencies - In the ordinary course of business, the Company becomes involved in litigation. Based upon the Company s internal records and discussions with legal counsel, the Company records reserves for estimates of the probable outcome of all cases brought against them. Except as discussed in Part II Other Information Item 1. Legal Proceedings, at June 30, 2010 the Company does not have any litigation reserves and is not aware of any material pending legal action or complaints asserted against the Company.

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## 2. INVESTMENTS

The amortized cost and estimated fair value of investment securities are shown below. The majority of securities held are publicly traded, and the estimated fair values were obtained from an independent pricing service based upon market quotes.


Approximately $66 \%$ of the available-for-sale portfolio represents securities issued by the U.S. government or U.S. government-sponsored enterprises, which guarantee payment of principal and interest.
The remaining CMO/REMICs are backed by agency-pooled collateral or whole loan collateral. All non-agency available-for-sale CMO/REMIC issues held are rated investment grade or better by either Standard \& Poor s or Moody s, as of June 30, 2010 and December 31, 2009.
Gross realized gains in our available-for-sale portfolio were $\$ 8.8$ million for the six months ended June 30, 2010 and $\$ 21.5$ million for the same period in 2009. There were no realized losses.

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Composition of the Fair Value and Gross Unrealized Losses of Securities:

(1) For the twelve months ended
December 31,
2009, the
Company
recorded \$1.7
million, on a

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pre-tax basis, of the non-credit portion of OTTI for this security in other comprehensive income, which is included as gross unrealized losses.
The tables above show the Company s investment securities gross unrealized losses and fair value by investment category and length of time that individual securities have been in a continuous unrealized loss position, at June 30, 2010 and December 31, 2009. The Company has reviewed individual securities to determine whether a decline in fair value below the amortized cost is other-than-temporary.
The following summarizes our analysis of these securities and the unrealized losses. This assessment was based on the following factors: i) the length of the time and the extent to which the fair value has been less than amortized cost; ii) adverse condition specifically related to the security, an industry, or a geographic area and whether or not the Company expects to recover the entire amortized cost, iii) historical and implied volatility of the fair value of the security; iv) the payment structure of the security and the likelihood of the issuer being able to make payments in the future; v.) failure of the issuer of the security to make scheduled interest or principal payments, vi) any changes to the rating of the security by a rating agency, and vii) recoveries or additional declines in fair value subsequent to the balance sheet date.
CMO Held-to-Maturity - We have one investment security classified as held-to-maturity. This security was issued by Countrywide Financial and is collateralized by Alt-A mortgages. The mortgages are primarily fixed-rate, $30-y e a r$ loans, originated in early 2006 with average FICO scores of 715 and an average LTV of $71 \%$ at origination. The security was a senior security in the securitization, was rated AAA at origination and was supported by subordinate securities. This security is classified as held-to-maturity as we have both the intent and ability to hold this debt security to maturity as the amount of the security, $\$ 3.2$ million, is not significant to our liquidity needs. We acquired this security in February 2008 at a price of $98.25 \%$. The significant decline in the fair value of the security first appeared in August 2008 as the current financial crisis in the markets occurred and the market for securities collateralized by Alt-A mortgages diminished.

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As of June 30, 2010, the unrealized loss on this security was $\$ 1.1$ million and the fair value on the security was $74 \%$ of the current par value. The security is rated non-investment grade. We evaluated the security for an other than temporary decline in fair value as of June 30, 2010. We assess for credit impairment using a cash flow model. The key assumptions include default rates, severities and prepayment rates. This security was determined to have additional credit impairment during the first quarter of 2010 due to continued degradation in expected cash flows primarily due to higher loss forecasts. We determined the amount of the credit impairment by discounting the expected future cash flows of the underlying collateral. We recognized an other-than-temporary impairment loss of $\$ 685,000$ during the first six months of 2010.
The following table provides a roll-forward of credit-related other-than-temporary impairment recognized in earnings for the six months ended June 30, 2010.
$\left.\begin{array}{l|l} & \begin{array}{c}\text { For the six } \\ \text { months ended }\end{array} \\ \text { June 30, 2010 } \\ \text { (in thousands) }\end{array}\right\}$

Reduction for securities with OTTI recognized in earnings because the security might be sold before recovery of its amortized cost basis

Addition of OTTI that was previously recognized because the security might not be sold before recovery of its amortized cost basis

Reduction for increases in cash flows expected to be collected that are recognized over the remaining life of the security

Balance, end of the period
\$ 1,008
Government Agency - The government agency bonds are backed by the full faith and credit of Agencies of the U.S. Government. These securities are bullet securities, that is, they have a defined maturity date on which the principal is paid. The contractual term of these investments provides that the Bank will receive the face value of the bond at maturity which will equal the amortized cost of the bond. Interest is received throughout the life of the security. There was no loss greater than 12 months on these securities at June 30, 2010.
Mortgaged-Backed Securities and CMO/REMICs - Almost all of the mortgage-backed and CMO/REMICs securities are issued by the government-sponsored enterprises such as Ginnie Mae, Fannie Mae and Freddie Mac. These securities are collateralized or backed by the underlying residential mortgages. All mortgage-backed securities are rated investment grade with an average life of approximately 3.7 years. The contractual cash flows of $98.0 \%$ of these investments are guaranteed by U.S. government-sponsored agencies. The remaining $2.0 \%$ are issued by banks. Accordingly, it is expected the securities would not be settled at a price less than the amortized cost of the bonds. The unrealized loss greater than 12 months on these securities at June 30, 2010 is $\$ 45,000$. This loss is primarily comprised of three bonds issued by non-government sponsored enterprises such as financial institutions. Because we believe the decline in fair value is attributable to the changes in interest rates and not credit quality and because the Company does not intend to sell the investments and it is more likely than not that the Company will not be required to sell the investments before recovery of their amortized costs, which may be at maturity, management does not consider these investments to be other than temporarily impaired at June 30, 2010.

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Municipal Bonds - Ninety-six percent of our $\$ 653.7$ million municipal bond portfolio contains securities which have an underlying rating of investment grade. The majority of our municipal bonds are insured by the largest bond insurance companies with maturities of approximately 5.4 years. The unrealized loss greater than 12 months on these securities at June 30, 2010 was $\$ 493,000$. The Bank diversifies its holdings by owning selections of securities from different issuers and by holding securities from geographically diversified municipal issuers, thus reducing the Bank s exposure to any single adverse event. Because we believe the decline in fair value is attributable to the changes in interest rates and not credit quality and because the Company does not intend to sell the investments and it is more likely than not that the Company will not be required to sell the investments before recovery of their amortized costs, which may be at maturity, management does not consider these investments to be other than temporarily impaired at June 30, 2010.
We are continually monitoring the quality of our municipal bond portfolio in light of the current financial problems exhibited by certain monoline insurance companies. While most of our securities are insured by these companies, we feel that there is minimal risk of loss due to the problems these insurers are having. Many of the securities that would not be rated without insurance are pre-refunded and/or are general obligation bonds. Based on our monitoring of the municipal marketplace, to our knowledge, none of the municipalities are exhibiting financial problems that would lead us to believe there is a loss in any given security.
At June 30, 2010 and December 31, 2009, investment securities having an amortized cost of approximately $\$ 1.88$ billion and $\$ 2.02$ billion respectively, were pledged to secure public deposits, short and long-term borrowings, and for other purposes as required or permitted by law.
The amortized cost and fair value of debt securities at June 30, 2010, by contractual maturity, are shown below. Although mortgage-backed securities and CMO/REMICs have contractual maturities through 2029, expected maturities will differ from contractual maturities because borrowers may have the right to prepay such obligations without penalty. Mortgage-backed securities and CMO/REMICs are included in maturity categories based upon estimated prepayment speeds.

|  | $\begin{array}{c}\text { Available-for-sale } \\ \text { Weighted- }\end{array}$ |  |  |  |
| :--- | ---: | ---: | ---: | ---: |
| Average |  |  |  |  |$]$

The investment in FHLB stock is periodically evaluated for impairment based on, among other things, the capital adequacy of the FHLB and its overall financial condition. No impairment losses have been recorded through June 30, 2010.

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## 3. FAIR VALUE INFORMATION

The following disclosure provides fair value information for financial assets and liabilities as of June 30, 2010 and December 31, 2009. The fair value hierarchy prioritizes the inputs to valuation techniques used to measure fair value into three broad levels (Level 1, Level 2, and Level 3).

Level 1 Valuation is based upon quoted prices for identical instruments traded in active markets. Level 2 Valuation is based upon quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market.
Level 3 Valuation is generated from model-based techniques that use significant assumptions not observable in the market. These unobservable assumptions reflect the Company s own estimates of assumptions that market participants would use in pricing the asset or liability. Valuation techniques include use of option pricing models, discounted cash flows and similar techniques.

## Determination of Fair Value

The following is a description of valuation methodologies used for assets and liabilities recorded at fair value and for estimating fair value for financial instruments not recorded at fair value.
Cash - The carrying amount of cash and cash equivalents is considered to be a reasonable estimate of fair value.
Investment securities available-for-sale - Investment securities available-for-sale are valued based upon quotes obtained from a reputable third-party pricing service. The service uses evaluated pricing applications and model processes. Market inputs, such as, benchmark yields, reported trades, broker/dealer quotes, issuer spreads, two-sided markets, benchmark securities, bids, offers and reference data are considered as part of the evaluation. The inputs are related directly to the security being evaluated, or indirectly to a similarly situated security. Market assumptions and market data are utilized in the valuation models. Accordingly, the Company categorized its investment portfolio as a Level 2 valuation.
Investment security held-to-maturity - Investment security held-to-maturity is carried at amortized cost-basis on the balance sheet. The fair value is determined using the same process described above for available-for-sale securities. During the first quarter ended, an other-than-temporary impairment loss was recognized and the carrying balance was reduced to fair value.
Non-covered Loans - The carrying amount of loans and lease finance receivables is their contractual amounts outstanding, reduced by deferred net loan origination fees and the allocable portion of the allowance for credit losses. The fair value of loans, other than loans on non-accrual status, was estimated by discounting the remaining contractual cash flows using the estimated current rate at which similar loans would be made to borrowers with similar credit risk characteristics and for the same remaining maturities, reduced by deferred net loan origination fees and the allocable portion of the allowance for credit losses. Accordingly, in determining the estimated current rate for discounting purposes, no adjustment has been made for any change in borrowers credit risks since the origination of such loans. Rather, the allocable portion of the allowance for credit losses is considered to provide for such changes in estimating fair value. As a result, this fair value is not necessarily the value which would be derived using an exit price.
Non-covered Impaired loans and OREO are generally measured using the fair value of the underlying collateral, which is determined based on the most recent appraisal information received, less costs to sell. Appraised values may be adjusted based on factors such as the changes in market conditions from the time of valuation or discounted cash flows of the property. As such, these loans fall within Level 3 of the fair value hierarchy.
The fair value of commitments to extend credit and standby letters of credit were not significant at either June 30, 2010 or December 31, 2009, as these instruments predominantly have adjustable terms and are of a short-term nature.

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Covered Loans - Covered loans were measured at fair value on the date of acquisition. Thereafter, covered loans are not measured at fair value on a recurring basis. The above valuation discussion for non-covered loans is applicable to covered loans following their acquisition date.
Swaps - The fair value of the interest rate swap contracts are provided by our counterparty using a system that constructs a yield curve based on cash LIBOR rates, Eurodollar futures contracts, and 3-year through 30-year swap rates. The yield curve determines the valuations of the interest rate swaps. Accordingly, the swap is categorized as a Level 2 valuation.
Deposits \& Borrowings - The amounts payable to depositors for demand, savings, and money market accounts, and the demand note to the U.S. Treasury, and short-term borrowings are considered to be stated at fair value. The fair value of fixed-maturity certificates of deposit is estimated using the rates currently offered for deposits of similar remaining maturities. The fair value of long-term borrowings and junior subordinated debentures is estimated using the rates currently offered for borrowings of similar remaining maturities.
Accrued Interest Receivable/Payable - The amounts of accrued interest receivable on loans and lease finance receivables and investments and accrued interest payable on deposits and borrowings are considered to be stated at fair value.
The table below presents the balances of assets and liabilities measured at fair value on a recurring basis as of June 30 , 2010 and December 31, 2009.

## Assets \& Liabilities Measured at Fair Value on a Recurring Basis

Quoted
$\left.\begin{array}{lccccc} & & \begin{array}{c}\text { Quoted } \\ \text { Prices in } \\ \text { Active } \\ \text { Markets }\end{array} & \begin{array}{c}\text { Significant }\end{array} & \begin{array}{c}\text { Other } \\ \text { Observable }\end{array} & \begin{array}{c}\text { Significant } \\ \text { Unobservable }\end{array} \\ \text { for Identical }\end{array}\right)$

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Assets \& Liabilities Measured at Fair Value on a Recurring Basis
Quoted
Prices in Significant

Active
Markets for Identical $\begin{array}{cc}\text { Other } & \text { Significant } \\ \text { Observable } & \text { Unobservable }\end{array}$

| (in thousands) |  | ing Value at mber 31, 2009 |  |  | $\begin{gathered} \text { Inputs } \\ \text { (Level 2) } \end{gathered}$ | Inputs <br> (Level 3) |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Description of Assets |  |  |  |  |  |  |
| U.S. Treasury securities | \$ | 507 | \$ | \$ | 507 | \$ |
| Mortgage-backed securities |  | 647,168 |  |  | 647,168 |  |
| CMO s/REMIC s |  | 773,165 |  |  | 773,165 |  |
| Government agency |  | 21,713 |  |  | 21,713 |  |
| Municipal bonds |  | 663,426 |  |  | 663,426 |  |
| Other securities |  | 2,484 |  |  | 2,484 |  |
| Investment Securities-AFS | \$ | 2,108,463 | \$ |  | 2,108,463 | \$ |
| Interest Rate Swaps |  | 4,334 |  |  | 4,334 |  |
| Total Assets | \$ | 2,112,797 | \$ |  | 2,112,797 | \$ |

Description of Liability
Interest Rate Swaps
\$ 4,334 \$
\$ 4,334 \$
We may be required to measure certain assets at fair value on a nonrecurring basis in accordance with GAAP. These adjustments to fair value usually result from application of lower-of-cost-or-market accounting or write-downs of individual assets. For assets measured at fair value on a nonrecurring basis that were still held in the balance sheet at June 30, 2010 and December 31, 2009, the following table provides the level of valuation assumptions used to determine each adjustment and the carrying value of the related assets.

Assets \& Liabilities Measured at Fair Value on a Non-Recurring Basis
Quoted
Prices in Significant
Active Markets Other Significant For the six months

Carrying Value for Identical Observable Unobservable | ended |
| :---: |
| June 30, |

| (in thousands) | $\begin{gathered} \text { at } \\ \text { June 30, } 2010 \end{gathered}$ |  | Assets <br> (Level 1) | Inputs <br> (Level 2) |  | Inputs (Level 3) |  | $\begin{gathered} 2010 \\ \text { Total Losses } \end{gathered}$ |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Description of Assets |  |  |  |  |  |  |  |  |  |
| Investment Security-HTM | \$ | 3,173 | \$ | \$ | 3,173 | \$ |  | \$ | (685) |
| Impaired Loans-Noncovered | \$ | 19,935 | \$ | \$ | 3,610 | \$ | 16,325 | \$ | $(7,469)$ |
| OREO-Noncovered | \$ | 15,001 | \$ | \$ |  | \$ | 15,001 | \$ | (667) |
| OREO-Covered | \$ | 5,092 | \$ | \$ |  | \$ | 5,092 | \$ |  |

## Assets \& Liabilities Measured at Fair Value on a Non-Recurring Basis

Quoted

| Prices in <br> Active | Significant |  | For the year |
| :---: | :---: | :---: | :---: |
| Markets | Other | Significant | ended <br> December |
| Oor Identical | Observable | Unobservable | 31, |


| (in thousands) | Carrying Value at December 31, |  | Assets | Inputs | puts | Inputs | puts | 2009 |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Description of Assets |  |  |  |  |  |  |  |  |  |
| Investment Security-HTM | \$ | 3,838 | \$ | \$ | 3,838 | \$ |  | \$ | (323) |
| Impaired Loans-Noncovered | \$ | 29,982 | \$ | \$ | 2,500 | \$ | 27,482 | \$ | $(18,450)$ |
| OREO-Noncovered | \$ | 3,936 | \$ | \$ |  | \$ | 3,936 | \$ | (848) |
| OREO-Covered | \$ | 5,565 | \$ | \$ |  | \$ | 5,565 | \$ |  |

The following table presents estimated fair value of financial instruments. The estimated fair value amounts have been determined by the Company using available market information and appropriate valuation methodologies. However, considerable judgment is required to develop the estimates of fair value. Accordingly, the estimates presented below are not necessarily indicative of the amounts the Company could have realized in a current market exchange as of June 30, 2010 and December 31, 2009. The use of different market assumptions and/or estimation methodologies may have a material effect on the estimated fair value amounts.

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## FAIR VALUE INFORMATION

|  | June 30, 2010 |  | December 31, 2009 |  |
| :---: | :---: | :---: | :---: | :---: |
|  | Carrying Amount | Estimated Fair Value (amounts | Carrying <br> Amount housands) | Estimated Fair Value |
| Assets |  |  |  |  |
| Cash and due from banks | \$ 451,236 | \$ 451,236 | \$ 103,254 | \$ 103,254 |
| Interest-bearing balances due from depository institutions | 50,274 | 50,274 | 1,226 | 1,226 |
| FHLB Stock | 93,962 | 93,962 | 97,582 | 97,582 |
| Investment securities available-for-sale | 2,011,492 | 2,011,492 | 2,108,463 | 2,108,463 |
| Investment securities held-to-maturity | 3,173 | 3,173 | 3,838 | 3,838 |
| Total Loans, net of allowance for credit losses | 3,810,773 | 3,894,229 | 3,970,089 | 3,955,500 |
| Accrued interest receivable | 26,967 | 26,967 | 28,672 | 28,672 |
| Swaps | 10,579 | 10,579 | 4,334 | 4,334 |
| Liabilities |  |  |  |  |
| Deposits: |  |  |  |  |
| Noninterest-bearing | \$ 1,646,717 | \$ 1,646,717 | \$ 1,561,981 | \$ 1,561,981 |
| Interest-bearing | 2,954,773 | 2,957,333 | 2,876,673 | 2,879,305 |
| Demand note to U.S. Treasury | 2,611 | 2,611 | 2,425 | 2,425 |
| Borrowings | 1,398,915 | 1,454,389 | 1,488,250 | 1,536,933 |
| Junior subordinated debentures | 115,055 | 115,867 | 115,055 | 115,817 |
| Accrued interest payable | 5,818 | 5,818 | 6,481 | 6,481 |
| Swaps | 10,579 | 10,579 | 4,334 | 4,334 |

The fair value estimates presented herein are based on pertinent information available to management as of June 30, 2010 and December 31, 2009. Although management is not aware of any factors that would significantly affect the estimated fair value amounts, such amounts have not been comprehensively revalued for purposes of these financial statements since that date, and therefore, current estimates of fair value may differ significantly from the amounts presented above.

## 4. BUSINESS SEGMENTS

The Company has identified two principal reportable segments: Business Financial and Commercial Banking Centers and the Treasury Department. The Company s subsidiary bank has 44 Business Financial Centers and 6 Commercial Banking Centers (branches), organized in 6 geographic regions, which are the focal points for customer sales and services. The Company utilizes an internal reporting system to measure the performance of various operating segments within the Bank which is the basis for determining the Bank s reportable segments. The Chief Operating Decision Maker (currently our CEO) regularly reviews the financial information of these segments in deciding how to allocate resources and assessing performance. The Bank s Business Financial and Commercial Banking Centers are considered one operating segment as their products and services are similar and are sold to similar types of customers, have similar production and distribution processes, have similar economic characteristics, and have similar reporting and organizational structures. The Treasury Department s primary focus is managing the Bank s investments, liquidity, and interest rate risk. Information related to the Company s remaining operating segments which include construction lending, dairy and livestock lending, SBA lending, leasing, and centralized functions have been aggregated and included in Other. In addition, the Company allocates internal funds transfer pricing to the segments using a methodology that charges users of funds interest expense and credits providers of funds interest income with the net effect of this allocation being recorded in administration.

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The following table represents the selected financial information for these two business segments. Accounting principles generally accepted in the United States of America do not have an authoritative body of knowledge regarding the management accounting used in presenting segment financial information. The accounting policies for each of the business units is the same as those policies identified for the consolidated Company and identified in the footnote on the summary of significant accounting policies. The income numbers represent the actual income and expenses of each business unit. In addition, each segment has allocated income and expenses based on management $s$ internal reporting system, which allows management to determine the performance of each of its business units. Loan fees, included in the Business Financial and Commercial Banking Centers category are the actual loan fees paid to the Company by its customers. These fees are eliminated and deferred in the Other category, resulting in deferred loan fees for the consolidated financial statements. All income and expense items not directly associated with the two business segments are grouped in the Other category. Future changes in the Company s management structure or reporting methodologies may result in changes in the measurement of operating segment results.
The following tables present the operating results and other key financial measures for the individual reportable segments for the three and six months ended June 30, 2010 and 2009:

|  | Business <br> Financial Centers |  | Six Months Ended June 30, 2010 |  |  |  |  |  | Total |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  |  |  | Treasury |  | Other |  | Eliminations |  |  |  |
| Interest income, including loan fees | \$ | 85,760 | \$ | 43,927 | \$ | 41,138 | \$ |  | \$ | 170,825 |
| Credit for funds provided (1) |  | 34,722 |  |  |  | 17,684 |  | $(52,406)$ |  |  |
| Total interest income |  | 120,482 |  | 43,927 |  | 58,822 |  | $(52,406)$ |  | 170,825 |
| Interest expense |  | 12,586 |  | 19,196 |  | 1,490 |  |  |  | 33,272 |
| Charge for funds used (1) |  | 6,574 |  | 19,091 |  | 26,741 |  | $(52,406)$ |  |  |
| Total interest expense |  | 19,160 |  | 38,287 |  | 28,231 |  | $(52,406)$ |  | 33,272 |
| Net interest income |  | 101,322 |  | 5,640 |  | 30,591 |  |  |  | 137,553 |
| Provision for credit losses |  |  |  |  |  | 23,200 |  |  |  | 23,200 |
| Net interest income after provision for credit losses | \$ | 101,322 | \$ | 5,640 | \$ | 7,391 | \$ | \$ | \$ | 114,353 |
| Non-interest income |  | 11,804 |  | 8,096 |  | $(6,693)$ |  |  |  | 13,207 |
| Non-interest expense |  | 26,300 |  | 6,440 |  | 44,629 |  |  |  | 77,369 |
| Segment pretax profit (loss) | \$ | 86,826 | \$ | 7,296 | \$ | $(43,931)$ | \$ | \$ | \$ | 50,191 |
|  |  | ,978,792 |  | 2,575,934 | \$ | 764,079 |  | \$ (1,458,409) |  | 6,860,396 |

Segment assets as of June 30, 2010

Six Months Ended June 30, 2009


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|  | Business <br> Financial <br> Centers |  | Treasury |  | ths Ended JuOther |  | 30 | 2010 |  | Total |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  |  |  | Eliminations |  |  |  |  |
| Interest income, including loan |  |  |  |  |  |  |  |  |  |  |
| Credit for funds provided (1) |  | 17,899 |  |  |  |  |  | 10,668 |  | $(28,567)$ |  |  |
| Total interest income |  | 60,907 |  | 21,123 |  | 26,810 |  | $(28,567)$ |  | 80,273 |
| Interest expense |  | 5,950 |  | 9,289 |  | 820 |  |  |  | 16,059 |
| Charge for funds used (1) |  | 3,053 |  | 10,235 |  | 15,279 |  | $(28,567)$ |  |  |
| Total interest expense |  | 9,003 |  | 19,524 |  | 16,099 |  | $(28,567)$ |  | 16,059 |
| Net interest income |  | 51,904 |  | 1,599 |  | 10,711 |  |  |  | 64,214 |
| Provision for credit losses |  |  |  |  |  | 11,000 |  |  |  | 11,000 |
| Net interest income after provision for credit losses | \$ | 51,904 | \$ | 1,599 | \$ | (289) | \$ |  | \$ | 53,214 |
| Non-interest income |  | 6,200 |  | 8,781 |  | 437 |  |  |  | 15,418 |
| Non-interest expense |  | 13,168 |  | 6,060 |  | 22,219 |  |  |  | 41,447 |
| Segment pretax profit (loss) | \$ | 44,936 | \$ | 4,320 | \$ | $(22,071)$ | \$ |  | \$ | 27,185 |
|  |  |  | Three Months Ended June 30, 2009 |  |  |  |  |  |  |  |
|  |  | usiness inancial Centers |  | reasury | Other |  | Eliminations |  |  | Total |
| Interest income, including loan fees |  | 38,556 | \$ | 26,030 | \$ | 11,189 | \$ |  | \$ | 75,775 |
| Credit for funds provided (1) |  | 12,717 |  |  |  | 5,233 |  | $(17,950)$ |  |  |
| Total interest income |  | 51,273 |  | 26,030 |  | 16,422 |  | $(17,950)$ |  | 75,775 |
| Interest expense |  | 7,300 |  | 13,188 |  | 1,192 |  |  |  | 21,680 |
| Charge for funds used (1) |  | 3,236 | \$ | 6,993 |  | 7,721 |  | $(17,950)$ |  |  |


| Total interest expense |  | 10,536 |  | 20,181 |  | 8,913 |  | $(17,950)$ |  | 21,680 |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Net interest income |  | 40,737 |  | 5,849 |  | 7,509 |  |  |  | 54,095 |
| Provision for credit losses |  |  |  |  |  | 20,000 |  |  |  | 20,000 |
| Net interest income after provision for credit losses | \$ | 40,737 | \$ | 5,849 | \$ | $(12,491)$ | \$ |  | \$ | 34,095 |
| Non-interest income |  | 4,800 |  | 12,619 |  | 2,290 |  |  |  | 19,709 |
| Non-interest expense |  | 12,363 | \$ | 377 |  | 20,239 |  |  |  | 32,979 |
| Segment pretax profit (loss) | \$ | 33,174 | \$ | 18,091 | \$ | $(30,440)$ | \$ |  | \$ | 20,825 |

(1) Credit for funds
provided and
charge for funds
used is
eliminated in
the consolidated
presentation.

## 5. DERIVATIVE FINANCIAL INSTRUMENTS

The Bank is exposed to certain risks relating to its ongoing business operations. The primary risks managed by using derivative instruments are market risk and interest rate risk. As of June 30, 2010, the Bank entered into 38 interest-rate swap agreements with customers and 38 with a counterparty bank. The swaps are not designated as hedging instruments. The purpose of entering into offsetting derivatives not designated as a hedging instrument is to provide the Bank a variable-rate loan receivable and provide the customer the financial effects of a fixed-rate loan without creating volatility in the bank s earnings.
The structure of the swaps is as follows. The Bank enters into a swap with its customers to allow them to convert variable rate loans to fixed rate loans, and at the same time, the Bank enters into a swap with the counterparty bank to allow the Bank to pass on the interest-rate risk associated with fixed rate loans. The net effect of the transaction allows the Bank to receive interest on the loan from the customer at a variable rate based on LIBOR plus a spread. The changes in the market value of the swaps primarily offset each other and therefore do not have a significant impact on the Company s results of operations.

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As of June 30, 2010, the total notional amount of the Bank s swaps was $\$ 267.6$ million. The following tables present the location of the asset and liability and the amount of gain recognized as of and for the three months ended June 30 , 2010.

## Fair Value of Derivative Instruments

|  | Asset Derivatives <br> June 30, 2010 |  |  | Liability Derivatives June 30, 2010 |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  | Balance |  |  | Balance |  |  |
| Derivatives Not Designated as | Sheet |  |  | Sheet |  |  |
| Hedging Instruments | Location |  | Value | Location |  | Value |
|  |  |  |  | Other |  |  |
| Interest Rate Swaps | Other Assets | \$ | 10,579 | Liabilities | \$ | 10,579 |
| Total Derivatives |  | \$ | 10,579 |  | \$ | 10,579 |

The Effect of Derivative Instruments on the Consolidated Statement of Earnings for six months ended June 30, 2010
(amounts in thousands)

|  | Location of Gain | Amount of Gain Recognized in Income |  |
| :---: | :---: | :---: | :---: |
|  |  | on Derivative |  |
| Derivatives Not Designated as | Recognized in Income on |  |  |
| Hedging Instruments | Derivative |  |  |
| Interest Rate Swaps | Other Income | \$ | 636 |
| Total |  | \$ | 636 |

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## ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

## GENERAL

Management s discussion and analysis is written to provide greater insight into the results of operations and the financial condition of CVB Financial Corp. and its subsidiaries. Throughout this discussion, Company refers to CVB Financial Corp. and its subsidiaries as a consolidated entity. CVB refers to CVB Financial Corp. as the unconsolidated parent company and Bank refers to Citizens Business Bank. For a more complete understanding of the Company and its operations, reference should be made to the financial statements included in this report and this discussion and analysis should be read in conjunction with the Company s 2009 Annual Report on Form 10-K. Certain statements in this Report on Form 10-Q constitute forward-looking statements under the Private Securities Litigation Reform Act of 1995 which involve risks and uncertainties. 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, local, regional, national and international economic conditions and events and the impact they may have on us and our customers; ability to attract deposits and other sources of liquidity; oversupply of inventory and continued deterioration in values of California real estate, both residential and commercial; a prolonged slowdown in construction activity; changes in the financial performance and/or condition of our borrowers; changes in the level of non-performing assets and charge-offs; the effect of acquisitions we may make; the effect of changes in laws and regulations (including laws and regulations concerning financial reform, taxes, banking, securities, executive compensation and insurance) with which we and our subsidiaries must comply; changes in estimates of future reserve requirements based upon the periodic review thereof under relevant regulatory and accounting requirements; inflation, interest rate, securities market and monetary fluctuations; political instability; acts of war or terrorism, or natural disasters, such as earthquakes, or the effects of pandemic flu; the timely development and acceptance of new banking products and services and perceived overall value of these products and services by users; changes in consumer spending, borrowing and savings habits; technological changes; the ability to increase market share and control expenses; changes in the competitive environment among financial and bank holding companies and other financial service providers; continued volatility in the credit and equity markets and its effect on the general economy; the effect of changes in accounting policies and practices, as may be adopted by the regulatory agencies, as well as the Public Company Accounting Oversight Board, the Financial Accounting Standards Board and other accounting standard setters; changes in our organization, management, compensation and benefit plans; the costs and effects of legal and regulatory developments including the resolution of legal proceedings or regulatory or other governmental inquiries and the results of regulatory examinations or reviews. For additional information concerning these factors and other factors which may cause actual results to differ from the results discussed in our forward-looking statements, see the periodic filings the Company makes with the Securities and Exchange Commission, and in particular Item 1A. Risk Factors contained in the Company s Annual Report on Form 10-K for the year ended December 31, 2009. The Company does not undertake, and specifically disclaims, any obligation to update any forward-looking statements to reflect the occurrence of events or circumstances after the date of such statements except as required by law.

## OVERVIEW

We are a bank holding company with one bank subsidiary, Citizens Business Bank. We have three other inactive subsidiaries: CVB Ventures, Inc.; Chino Valley Bancorp and Orange National Bancorp. We are also the common stockholder of CVB Statutory Trust I, CVB Statutory Trust II and CVB Statutory Trust III, statutory trusts which were formed to issue trust preferred securities in order to increase the capital of the Company. Through our acquisition of FCB in June 2007, we acquired FCB Capital Trust II, another statutory trust. We are based in Ontario, California in what is known as the Inland Empire of California. Our geographical market area encompasses the City of Stockton (the middle of the Central Valley) in the center of California to the City of Laguna Beach (in Orange County) in the southern portion of California. Our mission is to offer the finest financial products and services to professionals and businesses in our market area while maintaining a strong capital base and prudent loan loss reserves. We intend to grow our business through targeted efforts at our existing customers, attracting new associates who bring customers relationships with them and acquisitions.

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Our primary source of income is from the interest earned on our loans and investments and our primary area of expense is the interest paid on deposits, borrowings, and salaries and benefits. As such our net income is subject to fluctuations in interest rates and their impact on our income statement. We are also subject to competition from other financial institutions, which may affect our pricing of products and services, and the fees and interest rates we can charge on them.
Economic conditions in our California service area impact our business. We have seen a significant decline in the housing market resulting in slower growth in construction loans. Unemployment is high in our market areas and areas of our marketplace have been significantly impacted by adverse economic conditions, both nationally and in California. Approximately $22 \%$ of our total loan portfolio of $\$ 3.9$ billion is located in the Inland Empire region of California. The balance of the portfolio is from outside of this region. We continue to see the impact of deteriorating economic conditions on our loan portfolio. Continued weaknesses in the local and state economy could adversely affect us through diminished loan demand, credit quality deterioration, and increases in provisions for credit losses, loan delinquencies and defaults.
Over the past few years, we have been active in acquisitions and we will continue to consider acquisition targets, including FDIC-assisted acquisitions, which will enable us to meet our business objectives and enhance shareholder value along with organic growth. Since 2000, we have acquired five banks and a leasing company, and we have opened four de novo branches: Bakersfield, Fresno, Madera, and Stockton, California. We also opened six Commercial Banking Centers since 2008.
Our net income increased to $\$ 35.1$ million for the first six months of 2010 compared with $\$ 29.0$ million for the first six months of 2009, an increase of $\$ 6.1$ million, or $21.03 \%$. Diluted earnings per share increased to $\$ 0.33$ per share for 2010 , from $\$ 0.30$ per share for 2009 . Operating results for the first six months of 2010 include a $\$ 23.2$ million provision for credit losses, an $\$ 8.8$ million gain on sale of securities, and a $\$ 5.7$ million charge for the prepayment of borrowings.
For the quarter ended June 30, 2010, our net income increased to 19.0 million compared to $\$ 15.9$ million for the quarter ended June 30, 2009, an increase of 3.1 million, or $19.88 \%$. Diluted earnings per share were $\$ 0.18$ for the second quarter of 2010 compared to $\$ 0.17$ for the second quarter of 2009.
The operating results for the second quarter and first six months of 2010 were impacted by the accounting treatment of credit-related transactions from the San Joaquin Bank (SJB ) loan portfolio. For further discussion, see Analysis of the Results of Operations section of this Management s Discussion and Analysis of Financial Condition and Results of Operations.

## CRITICAL ACCOUNTING ESTIMATES

Critical accounting estimates are defined as those that are reflective of significant judgments and uncertainties, and could potentially result in materially different results under different assumptions and conditions. We believe that our most critical accounting estimates upon which our financial condition depends, and which involve the most complex or subjective decisions or assessments are as follows:
Allowance for Credit Losses: Arriving at an appropriate level of allowance for credit losses involves a high degree of judgment. Our allowance for credit losses provides for probable losses based upon evaluations of known and inherent risks in the loan portfolio. The determination of the balance in the allowance for credit losses is based on an analysis of the loan and lease finance receivables portfolio using a systematic methodology and reflects an amount that, in our judgment, is adequate to provide for probable credit losses inherent in the portfolio, after giving consideration to the character of the loan portfolio, current economic conditions, past credit loss experience, and such other factors as deserve current recognition in estimating inherent credit losses. The provision for credit losses is charged to expense. For a full discussion of our methodology of assessing the adequacy of the allowance for credit losses, see the Risk Management section of this Management s Discussion and Analysis of Financial Condition and Results of Operations.

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Investment Portfolio: The investment portfolio is an integral part of our financial performance. We invest primarily in fixed income securities. Accounting estimates are used in the presentation of the investment portfolio and these estimates do impact the presentation of our financial condition and results of operations. We classify securities as held-to-maturity those debt securities that we have the positive intent and ability to hold to maturity. Securities classified as trading are those securities that are bought and held principally for the purpose of selling them in the near term. All other debt and equity securities are classified as available-for-sale. Securities held-to-maturity are accounted for at cost and adjusted for amortization of premiums and accretion of discounts. Trading securities are accounted for at fair value with the unrealized holding gains and losses being included in current earnings. Securities available-for-sale are accounted for at fair value, with the net unrealized gains and losses, net of income tax effects, presented as a separate component of stockholders equity. At each reporting date, securities are assessed to determine whether there is an other-than-temporary impairment. Such impairment, if any, is required to be recognized in current earnings rather than as a separate component of stockholders equity. Realized gains and losses on sales of securities are recognized in earnings at the time of sale and are determined on a specific-identification basis. Purchase premiums and discounts are recognized in interest income using the effective-yield method over the terms of the securities. Our investment in Federal Home Loan Bank ( FHLB ) stock is carried at cost.
Income Taxes: We account for income taxes using the asset and liability method by deferring income taxes based on estimated future tax effects of differences between the tax and book basis of assets and liabilities considering the provisions of enacted tax laws. These differences result in deferred tax assets and liabilities, which are included in our balance sheets. We must also assess the likelihood that any deferred tax assets will be recovered from future taxable income and establish a valuation allowance for those assets determined to not likely be recoverable. Our judgment is required in determining the amount and timing of recognition of the resulting deferred tax assets and liabilities, including projections of future taxable income. Although we have determined a valuation allowance is not required for any of our deferred tax assets, there is no guarantee that these assets are recoverable.
Goodwill and Intangible Assets: We have acquired entire banks and branches of banks. Those acquisitions accounted for under the purchase method of accounting have given rise to goodwill and intangible assets. We record the assets acquired and liabilities assumed at their fair value. These fair values are arrived at by use of internal and external valuation techniques. The excess purchase price is allocated to assets and liabilities respectively, resulting in identified intangibles. The identified intangibles are amortized over the estimated lives of the assets or liabilities. Any excess purchase price after this allocation results in goodwill. Goodwill is tested on an annual basis for impairment.
Acquired Loans: Loans acquired from SJB were recorded at fair value as of the acquisition date. In estimating the fair value, the portfolio was segregated into two groups: credit-impaired covered loans and other covered loans. Credit-impaired loans are those loans showing evidence of credit deterioration since origination and it is probable, at the date of acquisition, that the Company will not collect all contractually required principal and interest payments. For the credit-impaired loans, the fair value was estimated by using observable market data for similar types of loans. For the other covered loans, the fair value was estimated by calculating the undiscounted expected cash flows based on estimated levels of prepayments, default factors, and loss severities and discounting the expected cash flows at a market rate. Significant estimates are used in calculating the fair value of acquired loans; as a result, actual results may be different than estimates.

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Fair Value of Financial Instruments: We use fair value measurements to record fair value adjustments to certain financial instruments and to determine fair value disclosures. Investment securities available-for-sale and interest-rate swaps are financial instruments recorded at fair value on a recurring basis. Additionally, from time to time, we may be required to record at fair value other financial assets on a non-recurring basis, such as impaired loans and OREO. These nonrecurring fair value adjustments typically involve application of lower-of-cost-or-market accounting or write-downs of individual assets. Further, we include in the Notes to Financial Statements information about the extent to which fair value is used to measure assets and liabilities, the valuation methodologies used and its impact to earnings. Additionally, for financial instruments not recorded at fair value we disclose the estimate of their fair value.

## ANALYSIS OF THE RESULTS OF OPERATIONS

## Earnings

We reported net earnings of $\$ 35.1$ million for the six months ended June 30, 2010. This represented an increase of $\$ 6.1$ million or $21.03 \%$, from net earnings of $\$ 29.0$ million for the six months ended June 30, 2009. Basic and diluted earnings per common share for the six-month period increased to $\$ 0.33$ per common share for 2010 , compared to $\$ 0.30$ per common share for 2009. The annualized return on average assets was $1.03 \%$ for the six months of 2010 compared to an annualized return on average assets of $0.90 \%$ for the six months of 2009. The annualized return on average equity was $10.77 \%$ for the six months ended June 30, 2010, compared to an annualized return of $9.29 \%$ for the six months ended June 30, 2009.
For the quarter ended June 30, 2009, our net earnings were $\$ 19.0$ million. This represents an increase of $\$ 3.1$ million, or $19.88 \%$, over net earnings of $\$ 15.9$ million for the second quarter of 2009. Basic and diluted earnings per common share increased to $\$ 0.18$ per share for the second quarter of 2010 compared to $\$ 0.17$ per share for the second quarter of 2009. The annualized return on average assets was $1.11 \%$ and $0.99 \%$ for the second quarter of 2010 and 2009, respectively. The annualized return on average equity was $11.44 \%$ and $9.99 \%$ for the second quarter of 2010 and 2009, respectively.

## Net Interest Income

The principal component of our earnings is net interest income, which is the difference between the interest and fees earned on loans and investments (earning assets) and the interest paid on deposits and borrowed funds (interest-bearing liabilities). Net interest margin is the taxable-equivalent of net interest income as a percentage of average earning assets for the period. The level of interest rates and the volume and mix of earning assets and interest-bearing liabilities impact net interest income and net interest margin. The net interest spread is the yield on average earning assets minus the cost of average interest-bearing liabilities. Our net interest income, interest spread, and net interest margin are sensitive to general business and economic conditions. These conditions include short-term and long-term interest rates, inflation, monetary supply, and the strength of the economy, in general, and the local economies in which we conduct business. Our ability to manage the net interest income during changing interest rate environments will have a significant impact on our overall performance. Our balance sheet is currently liability-sensitive; meaning interest-bearing liabilities will generally reprice more quickly than earning assets. Therefore, our net interest margin is likely to decrease in sustained periods of rising interest rates and increase in sustained periods of declining interest rates. We manage net interest income by affecting changes in the mix of earning assets as well as the mix of interest-bearing liabilities, changes in the level of interest-bearing liabilities in proportion to earning assets, and in the growth of earning assets.
Our net interest income, before the provision for credit losses, totaled $\$ 137.6$ million for the six months ended June 30, 2010. This represented an increase of $\$ 28.2$ million, or $25.75 \%$, over net interest income, before provision for credit losses, of $\$ 109.4$ million for the same period in 2009. The increase in net interest income of $\$ 28.2$ million resulted from a $\$ 16.1$ million increase in interest income and a $\$ 12.1$ million decrease in interest expense.

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Interest income totaled $\$ 170.8$ million for the first six months of 2010. This represented an increase of $\$ 16.1$ million, or $10.4 \%$, compared to total interest income of $\$ 154.7$ million for the same period last year. The increase in interest income is primarily due to a $\$ 17.9$ million discount accretion on covered loans acquired from SJB. The discount accretion represents accelerated principal payments on SJB loans and is recorded as a yield adjustment to interest income. As a result, average yield on earning assets increased to $5.75 \%$ for the six months of 2010 from $5.22 \%$ for the same period of 2009 , or 53 basis points. Average earning assets decreased by $\$ 33.7$ million, or $0.54 \%$, from $\$ 6.20$ billion to $\$ 6.16$ billion.
Interest expense totaled $\$ 33.3$ million for the first six months of 2010. This represented a decrease of $\$ 12.1$ million, or $26.63 \%$, from total interest expense of $\$ 45.4$ million for the same period last year. The decrease in interest expense was due to the decrease in average borrowings of $\$ 452.1$ million, from $\$ 1.97$ billion as of June 30,2009 to $\$ 1.51$ billion as of June 30, 2010. The average rate paid on interest-bearing liabilities decreased to $1.46 \%$ for the first six months of 2010 from $2.03 \%$ for the same period in 2009 , or 57 basis points. The average cost of deposits decreased to $0.70 \%$ for the first six months of 2010 from $1.10 \%$ for the same period in 2009 , or 40 basis points. The decrease in rates paid on deposits and borrowings was offset by an increase in average interest-bearing deposits of $\$ 529.8$ million, or $22.22 \%$, from $\$ 2.38$ billion to $\$ 2.91$ billion.
For the second quarter ended June 30, 2010, our net interest income, before provision for credit losses, totaled $\$ 64.2$ million. This represented an increase of $\$ 10.1$ million, or $18.71 \%$, over net interest income of $\$ 54.1$ million for the same period in 2009. The increase in net interest income of $\$ 10.1$ million resulted from an increase in interest income of 4.5 million and a decrease in interest expense of $\$ 5.6$ million.
Interest income totaled $\$ 80.3$ million for the second quarter of 2010. This represented an increase of $\$ 4.5$ million, or $5.94 \%$, compared to total interest income of $\$ 75.8$ million for the same period last year. The increase in interest income for the second quarter ending June 30, 2010 as compared to the second quarter ending June 30, 2009 was primarily due to a $\$ 4.5$ million discount accretion on covered loans acquired from SJB. This amount represents the discount recognized from accelerated principal payments on SJB loans. It is recorded as a yield adjustment to interest income.
Interest expense totaled $\$ 16.1$ million for the second quarter of 2009. This represented a decrease of $\$ 5.6$ million or $25.93 \%$, from total interest expense of $\$ 21.7$ million for the same period last year. The decrease in interest expense was due to the decrease in average borrowings of $\$ 237.5$ million, or $12.92 \%$. The average rate paid on interest-bearing liabilities decreased to $1.41 \%$ for the second quarter ending June 30, 2010 from $1.98 \%$ for the same period in 2009, or 57 basis points. The average cost of deposits decreased to $0.66 \%$ for the second quarter ending June 30, 2010 from $1.03 \%$ for the same period in 2009, or 37 basis points. The decrease in yields was offset by an increase in average interest-bearing deposits of $\$ 416.5$ million, or $16.62 \%$, from $\$ 2.51$ billion to $\$ 2.92$ billion.

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Table 1 shows the average balances of assets, liabilities, and stockholders equity and the related interest income, expense, and yields/rates for the three-month period and six-month period ended June 30, 2010 and 2009. Yields for tax-preferenced investments are shown on a taxable equivalent basis using a $35 \%$ tax rate.
TABLE 1 Distribution of Average Assets, Liabilities, and Stockholders Equity; Interest Rates and Interest Differentials

| Six-month period ended June 30, |  |  |  |  |  |
| :--- | :---: | :---: | :---: | :---: | :---: |
|  | 2010 | 2verage | Average |  |  |
| Average <br> Balance | Interest | Average <br> Yield/Rate <br> (amounts in thousands) | Interest | Averageld/Rate <br> Yield |  |

ASSETS
Investment Securities
Taxable
Tax preferenced (1)
Investment in FHLB stock
Federal Funds Sold \&
Interest Bearing
Deposits with other
institutions
Loans HFS
Loans (2) (3)
Total Earning Assets
Total Non Earning Assets
Total Assets
LIABILITIES AND
STOCKHOLDERS EQUITY

| Savings Deposits (4) | $\$ 1,696,482$ | $\$$ | 5,360 | $0.64 \%$ | $\$ 1,238,592$ | $\$ 5,004$ | $0.81 \%$ |
| :--- | ---: | ---: | ---: | ---: | ---: | ---: | ---: |
| Time Deposits | $1,217,496$ | 4,769 | $0.79 \%$ | $1,145,543$ | 8,025 | $1.41 \%$ |  |
|  |  |  |  |  |  |  |  |
| Total Deposits | $2,913,978$ | 10,129 | $0.70 \%$ | $2,384,135$ | 13,029 | $1.10 \%$ |  |
| Other Borrowings | $1,628,100$ | 23,143 | $2.83 \%$ | $2,080,233$ | 32,321 | $3.09 \%$ |  |
|  |  |  |  |  |  |  |  |
| Interest Bearing Liabilities | $4,542,078$ | 33,272 | $1.46 \%$ | $4,464,368$ | 45,350 | $2.03 \%$ |  |
| Non-interest bearing deposits | $1,598,199$ |  |  | $1,358,732$ |  |  |  |
| Other Liabilities | 53,874 |  |  | 71,677 |  |  |  |
| Stockholders Equity | 657,894 |  | 630,235 |  |  |  |  |
|  |  |  |  |  |  |  |  |
| Total Liabilities and | $\$ 6,852,045$ |  |  | $\$ 6,525,012$ |  |  |  |
| Stockholders Equity |  |  |  |  |  |  |  |


| Net interest income | \$ 137,553 | \$ 109,386 |
| :---: | :---: | :---: |
| Net interest spread tax equivalent | 4.29\% | 3.19\% |
| Net interest margin | 4.50\% | 3.57\% |
| Net interest margin tax equivalent | 4.67\% | 3.75\% |
| Net interest margin excluding |  |  |
| loan fees | 4.45\% | 3.52\% |
| Net interest margin excluding |  |  |
| loan fees tax equivalent | 4.62\% | 3.71\% |
| (1) Non tax-equivalent rate was 3.96\% for 2010, 4.12\% for 2009 |  |  |
| (2) Loan fees are included in total interest income as follows, (000)s omitted: 2010, \$1,567; 2009, \$ 1,393 |  |  |
| (3) Non-performing, non-covered loans are included in net loans as follows: 2010, <br> $\$ 82.9$ million; 2009, $\$ 51.3$ million |  |  |
| (4) Includes interest bearing demand and money market accounts |  |  |

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TABLE 1 Distribution of Average Assets, Liabilities, and Stockholders Equity; Interest Rates and Interest Differentials

|  | Three Months Ended June 30, |  |  |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  | Average Balance | 2010 | Average |  | 2009 | Average Rate |
|  |  | Interest |  | Average <br> Balance housands) | Interest |  |
| ASSETS |  |  |  |  |  |  |
| Investment Securities |  |  |  |  |  |  |
| Taxable | \$ 1,375,632 | \$ 14,391 | 4.18\% | \$ 1,642,964 | \$ 19,134 | 4.73\% |
| Tax preferenced (1) | 650,368 | 6,409 | 5.57\% | 663,168 | 6,815 | 5.79\% |
| Investment in FHLB stock | 95,792 | 63 | 0.26\% | 93,240 |  | 0.00\% |
| Federal Funds Sold \& Interest |  |  |  |  |  |  |
| Bearing |  |  |  |  |  |  |
| Deposits with other institutions | 50,222 | 238 | 1.90\% | 61,283 | 55 | 0.36\% |
| Loans HFS | 1,055 | 15 | 5.70\% |  |  |  |
| Loans (2) (3) | 3,937,448 | 59,157 | 6.03\% | 3,654,189 | 49,771 | 5.46\% |
| Total Earning Assets | 6,110,517 | 80,273 | 5.44\% | 6,114,844 | 75,775 | 5.17\% |
| Total Non Earning Assets | 755,688 |  |  | 326,919 |  |  |
| Total Assets | \$ 6,866,205 |  |  | \$ 6,441,763 |  |  |
| LIABILITIES AND |  |  |  |  |  |  |
| STOCKHOLDERS EQUITY |  |  |  |  |  |  |
| Savings Deposits (4) | \$ 1,727,842 | \$ 2,628 | 0.61\% | \$ 1,292,070 | \$ 2,439 | 0.76\% |
| Time Deposits | 1,194,717 | 2,213 | 0.74\% | 1,213,994 | 4,000 | 1.32\% |
| Total Deposits | 2,922,559 | 4,841 | 0.66\% | 2,506,064 | 6,439 | 1.03\% |
| Other Borrowings | 1,600,951 | 11,218 | 2.77\% | 1,838,419 | 15,241 | 3.28\% |
| Interest Bearing Liabilities | 4,523,510 | 16,059 | 1.41\% | 4,344,483 | 21,680 | 1.98\% |
| Non-interest bearing deposits | 1,621,507 |  |  | 1,375,054 |  |  |
| Other Liabilities | 54,589 |  |  | 85,547 |  |  |
| Stockholders Equity | 666,599 |  |  | 636,679 |  |  |
| Total Liabilities and |  |  |  |  |  |  |
| Stockholders Equity | \$ 6,866,205 |  |  | \$ 6,441,763 |  |  |
| Net interest income |  | \$ 64,214 |  |  | \$ 54,095 |  |


| Net interest spread tax |  |  |
| :--- | :--- | :---: |
| equivalent |  | $4.03 \%$ |
| Net interest margin | $4.22 \%$ | $3.19 \%$ |
| Net interest margin <br> equivalent | $4.39 \%$ | $3.57 \%$ |
| Net interest margin excluding <br> loan fees | $4.17 \%$ | $3.76 \%$ |
| Net interest margin excluding <br> loan fees tax equivalent | $4.34 \%$ | $3.53 \%$ |

(1) Non tax
equivalent rate was $3.94 \%$ for 2010 and $4.11 \%$ for 2009.
(2) Loan fees are included in total interest income as follows, (000)s omitted:

2010, \$816;
2009, \$ 679
(3) Non-performing, non-covered
loans are
included in net loans as follows, (000)s omitted:

2010,
$\$ 82.9$ million;
2009,
$\$ 51.3$ million
(4) Includes interest
bearing demand and money market accounts
As stated above, the net interest margin measures net interest income as a percentage of average earning assets. Our tax effected (TE) net interest margin was $4.67 \%$ for the first six months of 2010 , compared to $3.75 \%$ for the first six months of 2009. Our tax effected (TE) net interest margin for the second quarter of 2010 was $4.39 \%$, compared to $3.76 \%$ for the second quarter of 2009. The increase in the net interest margin over the same period last year is primarily the result of the $\$ 17.9$ million discount accretion on covered SJB loans which impacted interest income on loans. This was partially offset by changes in the mix of assets and liabilities as discussed in the following paragraphs. Generally, our net interest margin improves in a decreasing interest rate environment as our deposits and borrowings reprice much faster than our loans and securities.
The net interest spread is the difference between the yield on average earning assets and the cost of average interest-bearing liabilities. The net interest spread is an indication of our ability to manage rates received on loans and investments and rates paid on deposits and borrowings in a competitive and changing interest rate environment. Our

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net interest spread (TE) was $4.29 \%$ for the first six months of 2010 and $3.19 \%$ for the same period last year. The increase in the net interest spread for the six months ended June 30, 2010 resulted from a 53 basis point increase in the yield on earning assets and a 57 basis point decrease in the cost of interest-bearing liabilities, thus generating a 110 basis point increase in the net interest spread from the same period last year. The net interest spread was positively impacted by the $\$ 17.9$ million discount accretion on covered SJB loans recognized as a yield adjustment to interest income during the first quarter of 2010.

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For the second quarter of 2010, the Company s net interest spread (TE) was $4.03 \%$ as compared to $3.19 \%$ for the same period last year. The increase in net interest spread for the second quarter ended June 30, 2010 resulted from a 27 basis point increase in yield on earning assets and a 57 basis point decrease in the cost of interest-bearing liabilities, thus generating a 84 basis point increase in the net interest spread from the same period last year.
The yield (TE) on earning assets increased to $5.75 \%$ for the six months of 2010 , from $5.22 \%$ for the same period last year. Average loans as a percent of earning assets increased to $64.50 \%$ in the six months of 2010 over $59.19 \%$ for the same period in 2009. Average investments as a percent of earning assets decreased to $33.38 \%$ in the six months of 2010 from $38.80 \%$ for the same period in 2009. The yield on loans for the first six months of 2010 increased to $6.44 \%$ as compared to $5.46 \%$ for the same period in 2009 as a result of $\$ 17.9$ million discount accretion on SJB covered loans. The yield on loans decline at a slower rate than general interest rates as approximately $57 \%$ of the Company s loans are fixed-rate loans or hybrid adjustable loans with interest rates that are typically fixed for the first five years of the loans and reset at fixed rates for the remaining 5 -year terms. The yield (TE) on investments for the first six months of 2010 decreased to $4.74 \%$ compared to $5.11 \%$ for the same period in 2009 .
The cost of average interest-bearing liabilities decreased to $1.46 \%$ for the first six months of 2010 as compared to $2.03 \%$ for the same period in 2009 , reflecting a decrease in interest rates and change in the mix of interest-bearing liabilities. Average borrowings as a percent of average interest-bearing liabilities decreased to $35.84 \%$ during the first six months of 2010 as compared to $46.60 \%$ for the same period in 2009. Average borrowings were $\$ 1.63$ billion as of June 30, 2010. This represents a decrease of $\$ 452.1$ million or $21.73 \%$, from average borrowings of $\$ 2.08$ billion as of June 30, 2009. The cost of borrowings for the first six months of 2010 decreased to $2.83 \%$ as compared to $3.09 \%$ for the same period in 2009. Borrowings typically have a higher cost than interest-bearing deposits. The cost of interest-bearing deposits for the first six months of 2010 decreased to $0.70 \%$ as compared to $1.10 \%$ for the same period in 2009 , while average deposits increased $\$ 529.8$ million or $22.22 \%$ over the same periods. The FDIC has approved the payment of interest on certain demand deposit accounts. This could have a negative impact on our net interest margin, net interest spread, and net earnings, should this be implemented fully. Currently, we pay interest on NOW and Money Market Accounts. The overall decrease in interest rates and decrease in average borrowings, offset by an increase in average deposits, resulted in a decrease in our interest expense.
For the second quarter of 2010, the yield (TE) on earning assets increased to $5.44 \%$, from $5.17 \%$ for the same period last year. The cost of average interest-bearing liabilities decreased to $1.41 \%$ for the second quarter of 2010 as compared to $1.98 \%$ for the same period in 2009. The changes reflect the decreasing interest rate environment and change in mix of earning assets and interest-bearing liabilities, reflecting similar trends as described above.
Table 2 presents a comparison of interest income and interest expense resulting from changes in the volumes and rates on average earning assets and average interest-bearing liabilities for the periods indicated. Changes in interest income or expense attributable to volume changes are calculated by multiplying the change in volume by the initial average interest rate. The change in interest income or expense attributable to changes in interest rates is calculated by multiplying the change in interest rate by the initial volume. The changes attributable to both interest rate and volume changes are calculated by multiplying the change in rate times the change in volume.

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TABLE 2 Rate and Volume Analysis for Changes in Interest Income, Interest Expense and Net Interest Income

| Comparison of six months ended June 30, |  |  |
| :---: | :---: | :---: |
| 2010 Compared to 2009 |  |  |
| Increase (Decrease) Due to |  |  |
| Rate/ |  |  |
| Volume | Rate $\quad$Volume <br> (amounts in thousands) | Total |
|  |  |  |
|  |  |  |

Interest Income:

| $(11,095)$ |  |  |  |  |  |  |
| :--- | ---: | ---: | ---: | ---: | ---: | ---: |
| Taxable investment securities | $\$$ | $(7,644)$ | $\$$ | $(4,208)$ | $\$$ | 757 |
| Tax-advantaged securities | $(500)$ | $(366)$ | $(4)$ | $(870)$ |  |  |
| Fed funds sold \& interest-bearing deposits with |  |  |  |  |  |  |
| other institutions | 2 | 269 | 10 | 281 |  |  |
| Investment in FHLB stock |  | 126 | 3 | 129 |  |  |
| Loans HFS |  |  | 33 | 33 |  |  |
| Loans | 8,321 | 17,821 | 1,469 | 27,611 |  |  |
| Total interest on earning assets |  |  |  |  |  |  |
|  | 179 | 13,642 | 2,268 | 16,089 |  |  |


| Interest Expense: |  |  |  |  |  |
| :--- | :---: | :---: | :---: | :---: | :---: |
| Savings deposits | 1,839 | $(1,044)$ | $(455)$ | 340 |  |
| Time deposits | 503 | $(3,522)$ | $(221)$ | $(3,240)$ |  |
| Other borrowings | $(7,024)$ | $(2,719)$ | 565 | $(9,178)$ |  |
| Total interest on interest-bearing liabilities | $(4,682)$ | $(7,285)$ |  | $(111)$ | $(12,078)$ |
|  |  |  |  |  |  |
|  |  |  |  |  |  |
| Net Interest Income | $\$$ | 4,861 | $\$$ | 20,927 | $\$$ |

TABLE 2 Rate and Volume Analysis for Changes in Interest Income, Interest Expense and Net Interest Income

Interest Income:

| Taxable investment securities | $\$$ | $(2,851)$ | $\$$ | $(2,223)$ | $\$$ | 331 |
| :--- | ---: | ---: | ---: | ---: | ---: | ---: |
| Tax-advantaged securities | $(185)$ | $(223)$ |  | 2 | $(4,743)$ |  |
| Fed funds sold \& interest-bearing deposits with |  |  |  |  | $(43)$ | 183 |
| other institutions | $(10)$ | 236 |  | 2 | 63 |  |
| Investment in FHLB stock |  | 61 |  | 15 | 15 |  |
| Loans HFS |  |  |  | 337 | 9,386 |  |


| Total interest on earning assets | 810 | 3,044 | 644 | 4,498 |  |
| :--- | :---: | :---: | :---: | :---: | :---: |
|  |  |  |  |  |  |
| Interest Expense: | 826 | $(483)$ | $(151)$ | 192 |  |
| Savings deposits | $(63)$ | $(1,755)$ | 28 | $(1,790)$ |  |
| Time deposits | $(1,969)$ | $(2,370)$ | 316 | $(4,023)$ |  |
| Other borrowings | $(1,206)$ | $(4,608)$ | 193 | $(5,621)$ |  |
| Total interest on interest-bearing liabilities |  |  |  |  |  |
|  |  |  |  |  |  |
| Net Interest Income | $\$$ | 2,016 | $\$$ | 7,652 | $\$$ |

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## Interest and Fees on Loans

Our major source of revenue and primary component of interest income is interest and fees on loans. Interest and fees on loans totaled $\$ 126.9$ million for the first six months of 2010. This represented an increase of $\$ 27.6$ million, or $27.84 \%$, over interest and fees on loans of $\$ 99.3$ million for the same period in 2009. The increase in interest on loans was primarily due to the $\$ 17.9$ million discount accretion on covered loans acquired from SJB. This amount represents the discount recognized from accelerated principal payments on SJB loans. It is recorded as a yield adjustment to interest income. As a result, the yield on loans increased to $6.44 \%$ for the first six months of 2010, compared to $5.46 \%$ for the same period in 2009. Average loans increased $\$ 307.3$ million, or $8.38 \%$, from $\$ 3.67$ billion for the first six months of 2009 to $\$ 3.97$ billion for the first six months of 2010 due to the acquisition of SJB.
Interest and fees on loans totaled $\$ 59.2$ million for the second quarter of 2010. This represented an increase of $\$ 9.4$ million, or $18.89 \%$, over interest and fees on loans of $\$ 49.8$ million for the same period in 2009. The increase was due to the $\$ 4.5$ million discount accretion on covered loans acquired from SJB and increases in average loan balances.
In general, we stop accruing interest on a loan after its principal or interest becomes 90 days or more past due. When a loan is placed on nonaccrual, all interest previously accrued but not collected is charged against earnings. There was no interest income that was accrued and not reversed on non-performing loans at June 30, 2010 and 2009.
Fees collected on loans are an integral part of the loan pricing decision. Loan fees and the direct costs associated with the origination of loans are deferred and deducted from the loan balance. Deferred net loan fees are recognized in interest income over the term of the loan using the effective-yield method. We recognized loan fee income of $\$ 1.6$ million for the first six months of 2010, as compared to $\$ 1.4$ million for the same period in 2009, an increase of $\$ 175,000$ or $12.56 \%$.

## Interest on Investments

The second most important component of interest income is interest on investments, which totaled $\$ 43.4$ million for the first six months of 2010. This represented a decrease of $\$ 12.0$ million, or $21.61 \%$, from interest on investments of $\$ 55.4$ million for the same period in 2009. The decrease in interest on investments for the six months of 2010 from the same period last year was primarily the result of a decrease in yield on investments and a decrease in average investments. The interest rate environment and the investment strategies we employ directly affect the yield on the investment portfolio. We continually adjust our investment strategies in response to the changing interest rate environment in order to maximize the rate of total return consistent within prudent risk parameters, and to minimize the overall interest rate risk of the Company. The total yield (TE) on investments decreased to $4.74 \%$ for the first six months of 2010 compared to $5.11 \%$ for the first six months of 2009. Average investment balances for the first six months for 2010 decreased $\$ 341.1$ million, or $14.19 \%$ from the same period last year.
For the second quarter of 2010, interest income on investments totaled $\$ 20.8$ million. This represented a decrease of $\$ 5.1$ million or $19.84 \%$, from interest on investments of $\$ 25.9$ million for the same period in 2009. The decrease in interest on investments for the second quarter of 2010 from the same period last year reflected decreases in the average balance of investments and in the interest rates. The total yield (TE) on investments decreased to $4.63 \%$ for the second quarter of 2010 , compared to $5.04 \%$ for the same period in 2009 as a result of the decreasing interest rate environment.

## Interest on Deposits

Interest on deposits totaled $\$ 10.1$ million for the first six months of 2010. This represented a decrease of $\$ 2.9$ million, or $22.26 \%$, from interest on deposits of $\$ 13.0$ million for the first six months of 2009 . The decrease is due to the decrease in interest rates on deposits offset by increases in average interest-bearing deposit balances. The cost of interest-bearing deposits decreased to $0.70 \%$ for the first six months of 2010 from $1.10 \%$ for the first six months of 2009. The cost of total deposits decreased to $0.45 \%$ for the first six months of 2010 from $0.70 \%$ for the first six months of 2009. Average interest-bearing deposits increased $\$ 529.8$ million, or $22.22 \%$, over the same period last year.

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For the second quarter of 2010, interest on deposits totaled $\$ 4.8$ million. This represented a decrease of $\$ 2.0$ million, or $24.83 \%$, from interest on deposits of $\$ 6.4$ million for the same period in 2009. The decrease is due to the decrease in interest rates on deposit offset by increases in average interest-bearing deposit balances. The cost of interest-bearing deposits decreased to $0.66 \%$ for the second quarter of 2010 from $1.03 \%$ for the second quarter of 2009. The cost of total deposits decreased to $0.43 \%$ for the second quarter of 2010 from $0.67 \%$ for the second quarter of 2009 . Average interest-bearing deposits increased $\$ 416.5$ million, or $16.62 \%$, over the same period last year.

## Interest on Borrowings

Interest on borrowings totaled $\$ 21.5$ million for the first six months of 2010 . This represented a decrease of $\$ 8.6$ million, or $28.54 \%$, from interest on borrowings of $\$ 30.1$ million for the same period of 2009. The decrease is due to the decrease in average borrowings of $\$ 452.1$ million, or $21.73 \%$, compared to the same period last year. Interest rates on borrowings decreased to $2.83 \%$ for the first six months of 2010 from $3.05 \%$ first six months of 2009. For the second quarter of 2010 , interest on borrowings totaled $\$ 10.4$ million. This represented a decrease of $\$ 3.8$ million, or $26.89 \%$, from interest on borrowings of $\$ 14.2$ million for the same period of 2009. The decrease is due to the decrease in interest rates paid on borrowings and a decrease in average borrowings. Interest rates on borrowings decreased 49 basis points, from $3.26 \%$ for the second quarter of 2009 to $2.77 \%$ for the second quarter of 2010. Average borrowings decreased $\$ 237.5$ million, or $13.78 \%$.

## Provision for Credit Losses

We maintain an allowance for inherent credit losses that is increased by a provision for credit losses charged against operating results. The provision for credit losses is determined by management as the amount to be added to the allowance for probable credit losses after net charge-offs have been deducted to bring the allowance to an adequate level which, in management $s$ best estimate, is necessary to absorb probable credit losses within the existing loan portfolio.
We made a provision for credit losses of $\$ 23.2$ million during the first six months of 2010 and $\$ 42.0$ million during the same period in 2009. The decrease in the provision for credit losses during the first six months of 2010 was primarily due to the decrease in incremental classified assets from December 31, 2009 to June 30, 2010 compared to the same period last year. We continue to make provisions for credit losses in order to build our reserves based on historical losses and current economic indicators. We believe the allowance is appropriate as of the end of the period covered by this report. We continually assess the quality of our portfolio to determine whether additional provision for credit losses is necessary. We anticipate future provisions will be required to account for probable credit losses. The ratio of the allowance for credit losses to total loans as of June 30, 2010 and 2009 was $3.38 \%$ and $2.07 \%$, respectively. No assurance can be given that economic conditions which adversely affect the Company s service areas, past credit loss experience, the characteristics of our loan portfolio or other circumstances will not be reflected in increased provisions for credit losses in the future. The nature of this process requires considerable judgment. Net charge-offs totaled $\$ 13.6$ million for the first six months of 2010 and $\$ 21.2$ million during the same period of 2009. See Risk Management Credit Risk herein.

## Other Operating Income

Other operating income for the Company includes income derived from special services offered by the Bank, such as CitizensTrust, merchant card, international banking, and other business services. Also included in other operating income are service charges and fees, primarily from deposit accounts; gains (net of losses) from the sale of investment securities, other real estate owned, and fixed assets; and other revenues not included as interest on earning assets.

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We reported other operating income of 13.2 million for the first six months of 2010, compared to other operating income of $\$ 36.1$ million during the same period of 2009 . This represents a decrease of $\$ 22.9$ million, or $63.38 \%$ partially due to a $\$ 12.2$ million reduction in the FDIC loss sharing asset during the first six months of 2010. During the first six months of 2010, we sold $\$ 162.8$ million in securities in recognized a gain on sale of $\$ 8.8$ million. In contrast, during the first six months of 2009 , we realized a gain on sale of securities of $\$ 21.5$ million.
During the first six months of 2010, we reported increases in service charge fee income, trust and investment services income, BOLI income and bankcard services income compared to the same period last year. Service charge fee income of $\$ 8.5$ million for the six months ended June 30, 2010 increased $\$ 1.1$ million, or $14.96 \%$, over service charge fee income of $\$ 7.4$ million for the same period last year. Trust and investment services income of $\$ 4.3$ million during the first six months of 2010 increased $\$ 1.1$ million, or $32.53 \%$, over trust and investment service income of $\$ 3.3$ million during the first six months of 2009.
Other operating income totaled $\$ 15.4$ million for the quarter ended June 30, 2010. This represents a decrease of $\$ 4.3$ million, or $21.77 \%$, from total other operating income of $\$ 19.7$ million for the quarter ended June 30, 2009. The decrease was primarily due to the gain on sale of securities of $\$ 12.6$ million during the quarter ended June 30, 2009 compared to a gain on sale of securities of $\$ 8.8$ million and reduction in FDIC loss sharing asset of $\$ 1.6$ million during the quarter ended June 30, 2010.
During the second quarter of 2010, we reported increases in service charge fee income, trust and investment services income, BOLI income, and bankcard income compared to the same period last year. Service charge fee income of $\$ 4.2$ million for the quarter ended June 30, 2010 increased $\$ 553,000$, or $15.18 \%$, over service charge fee income of $\$ 3.6$ million for the same period last year. Trust and investment services income of $\$ 2.2$ million during the second quarter of 2010 increased $\$ 605,000$, or $37.71 \%$, over trust and investment services income of $\$ 1.6$ million during the second quarter of 2009.

## Other Operating Expenses

Other operating expenses for the Company include expenses for salaries and benefits, occupancy, equipment, stationary and supplies, professional services, amortization of intangibles, and other expenses. Other operating expenses totaled $\$ 77.4$ million for the first six months of 2010 . This represents an increase of $\$ 13.0$ million, or $20.18 \%$ over other operating expenses of $\$ 64.4$ million for the same period in 2009 . This was primarily due to a $\$ 5.7$ million prepayment charge on borrowings and an increase in salaries and employee expenses of $\$ 4.4$ million, or $13.97 \%$, as a result of the acquisition of SJB. In addition, professional services expenses were up $\$ 2.3$ million, or $69.66 \%$, compared to the same period last year, primarily due to increases in acquisition costs, as well as, legal expenses for the management of non-accrual loans and OREO.
For the second quarter of 2010, other operating expenses totaled $\$ 41.4$ million. This represents an increase of $\$ 8.5$ million, or $25.68 \%$, over other operating expenses of $\$ 33.0$ million for the same period last year.
At June 30, 2010, we employed 774 full time equivalent employees, compared to 686 full time equivalent employees at June 30, 2009.
For the most part, other operating expenses reflect the direct expenses and related administrative expenses associated with staffing, maintaining, promoting, and operating branch facilities. Our ability to control other operating expenses in relation to asset growth can be measured in terms of other operating expenses as a percentage of average assets. Operating expenses measured as a percentage of average assets was $2.28 \%$ and $1.99 \%$ for the first six months of 2010 and 2009 , respectively.

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Our ability to control other operating expenses in relation to the level of net revenue (net interest income plus other operating income) is measured by the efficiency ratio and indicates the percentage of net revenue that is used to cover expenses. For the first six months of 2010, the efficiency ratio was $60.65 \%$, compared to a ratio of $62.23 \%$ for the same period in 2009. The efficiency ratio, before the provision for credit losses, was $51.32 \%$ for the first six months of 2010 and $44.26 \%$ for the first six months of 2009. The increase in the efficiency ratio was primarily due to the $\$ 5.7$ million prepayment charge on borrowings as discussed above.

## Income Taxes

The Company s effective tax rate for the three and six months of 2010 was $30.06 \%$ and $30.00 \%$, compared to $23.84 \%$ and $25.71 \%$ for the same period in 2009. The effective tax rates are below the nominal combined Federal and State tax rates as a result of the tax-preferenced income from certain investments and municipal loans/leases as a percentage of total income for each period. The majority of tax preferenced income is derived from municipal securities.

## RESULTS BY BUSINESS SEGMENTS

We have two reportable business segments: Business Financial and Commercial Banking Centers, and Treasury. The results of these two segments are included in the reconciliation between business segment totals and our consolidated total. Our business segments do not include the results of administration units that do not meet the definition of an operating segment.

## Business Financial and Commercial Banking Centers

Key measures we use to evaluate the Business Financial and Commercial Banking Center s performance are included in the following table for the three and six months ended June 30, 2010 and 2009. The table also provides additional significant segment measures useful to understanding the performance of this segment.


## Key Measures:

Statement of Operations

|  | $\$$ | 120,482 | $\$$ | 99,728 | $\$$ | 60,907 | $\$$ | 51,273 |
| :--- | ---: | ---: | ---: | ---: | ---: | ---: | ---: | ---: |
| Interest income (1) |  | 19,160 |  | 21,265 |  | 9,003 |  | 10,536 |
| Interest expense (1) | $\$$ | 101,322 | $\$$ | 78,463 | $\$$ | 51,904 | $\$$ | 40,737 |
| Net Interest Income |  |  |  |  |  |  | 4,800 |  |
|  |  | 11,804 |  | 9,612 |  | 6,200 |  | 12,363 |
| Non-interest income |  | 26,300 |  | 24,703 |  | 13,168 |  |  |
| Non-interest expense | $\$$ | 86,826 | $\$$ | 63,372 | $\$$ | 44,936 | $\$$ | 33,174 |

Balance Sheet
Average loans
Average non-interest bearing deposits
Average interest-bearing deposits
Yield on loans (2)
Rate paid on deposits

| $\$ 4,150,731$ | $\$ 3,667,152$ | $\$ 4,101,302$ | $\$ 3,654,189$ |
| ---: | ---: | ---: | ---: |
| $\$ 1,598,199$ | $\$ 1,358,732$ | $\$ 1,621,507$ | $\$ 1,375,054$ |
| $\$ 2,913,978$ | $\$ 2,384,135$ | $\$ 2,922,559$ | $\$ 2,506,064$ |
| $5.30 \%$ | $5.46 \%$ | $5.35 \%$ | $5.46 \%$ |
| $0.70 \%$ | $1.10 \%$ | $0.66 \%$ | $1.03 \%$ |

(1) Interest income and interest expense include credit for funds provided and
charge for funds
used,
respectively.
These are
eliminated in
the consolidated presentation.
(2) Yield on loans
excludes SJB
discount
accretion as this
is accounted for
at the corporate level.
For the six months ended June 30, 2010, segment profit increased by $\$ 23.5$ million, or $37.01 \%$, compared to the same period last year. This was primarily due to the increase in net interest income of $\$ 22.9$ million, or $29.13 \%$, due to increases in loan balances as a result of the SJB acquisition. Average loan balances increased $\$ 483.6$ million or $13.19 \%$, from the same period last year. This increase was offset by a decrease in loan yield of 16 basis points. Rates paid on deposits decreased 40 basis points, while average interest-bearing deposits increased $\$ 529.8$ million, or $22.22 \%$. Non-interest income increased by $\$ 2.2$ million, or $22.80 \%$, compared to the first six months of 2009 . Non-interest expense increased $\$ 1.6$ million, or $6.46 \%$, compared to the same period last year.

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For the quarter ended June 30, 2010, segment profit increased by $\$ 11.8$ million, or $35.46 \%$, compared to the same period last year. This was primarily due to the increase in net interest income. Non-interest income increased by $\$ 1.4$ million, or $29.17 \%$, compared to the quarter ended June 30, 2009. Non-interest expense increased $\$ 805,000$, or $6.51 \%$, compared to the same period last year.

## Treasury

Key measures we use to evaluate the Treasury s performance are included in the following table for the three and six months ended June 30, 2010 and 2009. The table also provides additional significant segment measures useful to understanding the performance of this segment.


Key Measures:
Statement of Operations

| Interest income (1) | \$ | 43,927 | \$ | 55,489 | \$ | 21,123 | \$ | 26,030 |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Interest expense (1) |  | 38,287 |  | 39,286 |  | 19,524 |  | 20,181 |
| Net Interest Income | \$ | 5,640 | \$ | 16,203 | \$ | 1,599 | \$ | 5,849 |
| Non-interest income (expense) |  | 8,096 |  | 21,548 |  | 8,781 |  | 12,619 |
| Non-interest expense |  | 6,440 |  | 739 |  | 6,060 |  | 377 |
| Segment pretax profit (loss) | \$ | 7,296 | \$ | 37,012 | \$ | 4,320 | \$ | 18,091 |
| Balance Sheet |  |  |  |  |  |  |  |  |
| Average investments |  | 2,185,756 |  | 2,528,355 |  | 2,172,014 |  | 2,460,655 |
| Average borrowings |  | 1,513,045 |  | 1,965,178 |  | 1,485,896 |  | ,723,364 |
| Yield on investments-TE |  | 4.74\% |  | 5.11\% |  | 4.63\% |  | 5.04\% |
| Non-tax equivalent yield |  | 3.96\% |  | 4.12\% |  | 3.96\% |  | 4.11\% |
| Rate paid on borrowings |  | 2.83\% |  | 3.05\% |  | 2.77\% |  | 3.26\% |

(1) Interest income and interest expense include credit for funds provided and charge for funds used, respectively. These are eliminated in the consolidated presentation.
For the six months ended June 30, 2010, segment profits decreased by $\$ 29.7$ million from the same period last year. The decrease is primarily due to the $\$ 21.5$ million gain on sale of securities recognized during the first six months of 2009 and the decrease in net interest income of $\$ 10.6$ million year over year. The decrease in net interest income is due to the decrease in average investments of $\$ 342.6$ million, or $13.55 \%$, and a decrease in yield on investments of 37 basis points from the six months ended June 30, 2009.

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For the quarter ended June 30, 2010, segment profit decreased by $\$ 13.8$ million over the same period last year. This is due to a decrease of $\$ 4.9$ million, or $18.85 \%$, in interest income on investments year over year. In addition, we recognized a $\$ 12.6$ million gain on sale of securities during the three months ended June 30, 2009 compared to a gain on sale of securities of $\$ 8.8$ million during the three months ended June 30, 2010.
There are no provisions for credit losses or taxes in the segments as these are accounted for at the corporate level.

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## Other

|  | Six months ended June 30, |  |  |  | Three months ended June 30, |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  |  | 2010 |  | 2009 |  | 2010 |  | 2009 |
|  | (amounts in thousands) |  |  |  |  |  |  |  |
| Key Measures: |  |  |  |  |  |  |  |  |
| Statement of Operations |  |  |  |  |  |  |  |  |
| Interest income (1) | \$ | 58,822 | \$ | 31,902 | \$ | 26,810 | \$ | 16,422 |
| Interest expense (1) |  | 28,231 |  | 17,182 |  | 16,099 |  | 8,913 |
| Net interest income | \$ | 30,591 | \$ | 14,720 | \$ | 10,711 | \$ | 7,509 |
| Provision for Credit Losses |  | 23,200 |  | 42,000 |  | 11,000 |  | 20,000 |
| Non-interest income (expense) |  | $(6,693)$ |  | 4,906 |  | 437 |  | 2,290 |
| Non-interest expense |  | 44,629 |  | 38,934 |  | 22,219 |  | 20,239 |
| Pre-tax loss | \$ | $(43,931)$ | \$ | $(61,308)$ | \$ | $(22,071)$ | \$ | $(30,440)$ |

(1) Interest income and interest expense include credit for funds provided and charge for funds used, respectively.
These are eliminated in the consolidated presentation.
The Company s administration and other operating departments reported pre-tax loss of $\$ 43.9$ million for the first six months of 2010. This represents a decrease in pre-tax loss of $\$ 17.4$ million or $28.34 \%$, from a pre-tax loss of $\$ 61.3$ million for the same period in 2009. The decrease in pre-tax loss is primarily attributed to the decrease in provision for credit losses of $\$ 18.8$ million. The increase in net interest income of $\$ 15.9$ million is primarily due to the $\$ 17.9$ million discount accretion on SJB loans. This is offset by a decrease in non-interest income (expense) of $\$ 11.6$ million which is primarily due to the reduction in the FDIC loss sharing asset of $\$ 12.2$ million.
For the quarter ended June 30, 2010, the company s administration and other operating departments reported pre-tax loss of $\$ 22.1$ million. This represents a decrease of $\$ 8.4$ million or $27.49 \%$, from a pre-tax loss of $\$ 30.4$ million for the same period in 2009. The decrease in pre-tax loss is primarily attributed to the decrease in provision for credit losses of $\$ 9.0$ million.

## ANALYSIS OF FINANCIAL CONDITION

The Company reported total assets of $\$ 6.86$ billion at June 30, 2010. This represented an increase of $\$ 120.6$ million, or $1.79 \%$, over total assets of $\$ 6.74$ billion at December 31, 2009 primarily due to an increase in cash and due from banks of $\$ 348.0$ million, or $337.02 \%$, offset by a decrease in earning assets. Earning assets totaled $\$ 5.97$ billion at June 30, 2010. This represented a decrease of $\$ 210.4$ million, or $3.40 \%$, from total earning assets of $\$ 6.18$ billion at December 31, 2009, due to a decrease in both loans and investments. Total liabilities were $\$ 6.19$ billion at June 30, 2010, up $\$ 84.9$ million, or $1.39 \%$, over total liabilities of $\$ 6.10$ billion at December 31, 2009. Total equity increased
$\$ 35.8$ million, or $5.60 \%$, to $\$ 674.0$ million at June 30, 2010, compared with total equity of $\$ 638.2$ million at December 31, 2009.

## Investment Securities

The Company reported total investment securities of $\$ 2.01$ billion at June 30, 2010. This represented a decrease of $\$ 97.6$ million, or $4.62 \%$, from total investment securities of $\$ 2.11$ billion at December 31, 2009. Investment securities comprise $33.73 \%$ of the Company s total earning assets at June 30, 2010.
Securities held as available-for-sale are reported at fair value for financial reporting purposes. The related unrealized gains or losses, net of income taxes, are recorded in stockholders equity. At June 30, 2010, securities held as available-for-sale had a fair value of $\$ 2.01$ billion, representing $99.8 \%$ of total investment securities, with an amortized cost of $\$ 1.94$ billion. At June 30, 2010, the net unrealized holding gain on securities available-for-sale was $\$ 75.1$ million and that resulted in accumulated other comprehensive income of $\$ 42.9$ million (net of $\$ 32.2$ million in deferred taxes). At December 31, 2009, the Company reported net unrealized gain on investment securities available-for-sale of $\$ 47.2$ million and accumulated other comprehensive income of $\$ 26.4$ million (net of deferred taxes of $\$ 20.8$ million).

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Table 3 sets forth investment securities available-for-sale at June 30, 2010 and December 31, 2009.
Table 3 Composition of Investment Securities (amounts in thousands)

| June 30, 2010 | December 31, 2009 |  |
| :---: | :---: | :---: |
| Fair Value | Total | Total |
| Percent | Fair Value | Percent |

Investment Securities Available-for-Sale:

| U.S. Treasury securities | $\$$ |  | $0.00 \%$ | $\$$ | 507 |
| :--- | ---: | ---: | ---: | ---: | ---: |
| Mortgage-backed securities |  | 574,734 | $28.57 \%$ | 647,168 | $30.02 \%$ |
| CMO s / REMIC s s | 560,652 | $27.87 \%$ | 773,165 | $36.67 \%$ |  |
| Government agency | 219,867 | $10.93 \%$ | 21,713 | $1.03 \%$ |  |
| Municipal bonds | 653,653 | $32.50 \%$ | 663,426 | $31.46 \%$ |  |
| Other securities | 2,586 | $0.13 \%$ | 2,484 | $0.12 \%$ |  |
|  |  |  |  |  |  |
| Total Investment Securities | $\$ 2,011,492$ | $100.00 \%$ | $\$ 2,108,463$ | $100.00 \%$ |  |

The weighted-average yield (TE) on the investment portfolio at June 30, 2010 was $4.00 \%$ with a weighted-average life of 4.1 years. This compares to a yield of $4.41 \%$ at December 31, 2009 with a weighted-average life of 4.7 years and a yield of $4.66 \%$ at June 30,2009 with a weighted-average life of 4.8 years. The weighted average life is the average number of years that each dollar of unpaid principal due remains outstanding. Average life is computed as the weighted-average time to the receipt of all future cash flows, using as the weights the dollar amounts of the principal paydowns.
Approximately $66 \%$ of the available-for-sale portfolio represents securities issued by the U.S. government or U.S. government-sponsored enterprises, which guarantee payment of principal and interest.
The remaining CMO/REMICs are backed by agency-pooled collateral or whole loan collateral. All non-agency available-for-sale CMO/REMIC issues held are rated investment grade or better by either Standard \& Poor s or Moody s, as of June 30, 2010 and December 31, 2009.

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Composition of the Fair Value and Gross Unrealized Losses of Securities:

(1) For the twelve months ended
December 31,
2009, the
Company
recorded
$\$ 1.7$ million, on
a pre-tax basis,
of the non-credit
portion of OTTI
for this security
in other
comprehensive
income, which
is included as
gross unrealized losses.
The tables above show the Company s investment securities gross unrealized losses and fair value by investment category and length of time that individual securities have been in a continuous unrealized loss position, at June 30, 2010 and December 31, 2009. The Company has reviewed the individual securities to determine whether a decline in fair value below the amortized cost basis is other-than-temporary. A summary of our analysis of these securities and the unrealized losses is described more fully in Note 2 Investment Securities in the notes to the consolidated financial statements. Economic trends may adversely affect the value of the portfolio of investment securities that we hold.
During the first six months of 2010 , the Company recognized an other-than-temporary impairment on the held-to-maturity investment security. The credit-impairment loss of $\$ 685,000$ was recognized as an offset to other operating income.

## Loans

At June 30, 2010, we reported total loans, net of deferred loan fees, of $\$ 3.9$ billion. This represents a decrease of $\$ 149.7$ million, or $3.67 \%$, from total loans, net of deferred loan fees, of $\$ 4.08$ billion at December 31, 2009. Total loans, net of deferred loan fees, comprise $65.80 \%$ of our total earning assets. The following tables present our loan portfolio, segregated into covered versus non-covered loans, by category as of June 30, 2010 and December 31, 2009.

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Table 4 Distribution of Loan Portfolio by Type (Dollar amounts in thousands)

|  | Non-Covered |  |  |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  | Loans |  | Covered |  | Total |  |
|  |  |  | Loans |  |  |  |
| Commercial and Industrial | \$ | 456,200 | \$ | 57,283 | \$ | 513,483 |
| Real Estate: |  |  |  |  |  |  |
| Construction |  | 185,237 |  | 120,487 |  | 305,724 |
| Commercial Real Estate |  | 2,003,439 |  | 317,818 |  | 2,321,257 |
| SFR Mortgage |  | 246,812 |  | 7,687 |  | 254,499 |
| Consumer |  | 62,282 |  | 11,060 |  | 73,342 |
| Municipal lease finance receivables |  | 153,262 |  | 780 |  | 154,042 |
| Auto and equipment leases, net of unearned discount |  | 23,754 |  |  |  | 23,754 |
| Dairy and Livestock/Agribusiness |  | 379,793 |  | 68,655 |  | 448,448 |
| Gross Loans |  | 3,510,779 | \$ | 583,770 |  | 4,094,549 |
| Less: Purchase Accounting Discount |  |  |  | $(159,393)$ |  | $(159,393)$ |
| Less: Deferred net loan fees |  | $(5,835)$ |  |  |  | $(5,835)$ |
| Gross loans, net of deferred loan fees |  | 3,504,944 | \$ | 424,377 |  | \$ 3,929,321 |
| Less: Allowance for credit losses |  | $(118,548)$ |  |  |  | $(118,548)$ |
| Net Loans |  | 3,386,396 | \$ | 424,377 |  | \$ 3,810,773 |

Allowance for Credit Losses as a \% of Loans, net of deferred loan fees
$3.38 \%$
$3.02 \%$

December 31, 2009
Non-Covered

|  | Covered <br> Loans |  |  |  |
| :--- | ---: | ---: | ---: | ---: |
| Commercial and Industrial | Loans | Total |  |  |
| Real Estate: | $\$ 13,715$ | $\$$ | 61,802 | $\$$ |
| Construction |  | 475,517 |  |  |
| Commercial Real Estate | 265,444 |  | 136,065 | 401,509 |
| SFR Mortgage | $1,989,644$ | 357,140 | $2,346,784$ |  |
| Consumer | 265,543 | 17,510 | 283,053 |  |
| Municipal lease finance receivables | 67,693 | 11,066 | 78,759 |  |
| Auto and equipment leases, net of unearned discount | 159,582 | 983 | 160,565 |  |
| Dairy and Livestock/Agribusiness | 30,337 |  | 30,337 |  |
|  | 422,958 |  | 70,493 | 493,451 |
| Gross Loans |  |  |  |  |
|  | $\$ 3,614,916$ | $\$$ | 655,059 | $\$ 4,269,975$ |
| Less: Purchase Accounting Discount |  |  | $(184,419)$ | $(184,419)$ |
| Less: Deferred net loan fees |  | $(6,537)$ |  | $(6)$ |

Gross loans, net of deferred loan fees
Less: Allowance for credit losses
Net Loans
$\begin{gathered}\$ 3,608,379 \\ (108,924)\end{gathered} \quad \$ \quad 470,634 \quad \begin{array}{r}\$ 4,079,013 \\ (108,924)\end{array}$
\$ 3,499,455 \$ 470,634 \$ 3,970,089

Allowance for Credit Losses as a \% of Loans, net of deferred loan fees
3.02\%
2.67\%

Commercial and industrial loans are loans and leases to commercial entities to finance capital purchases or improvements, or to provide cash flow for operations. Real estate loans are loans secured by trust deeds on real property, including property under construction, commercial property and single family and multifamily residences. Consumer loans include installment loans to consumers as well as home equity loans and other loans secured by junior liens on real property. Municipal lease finance receivables provide financing to municipalities, school districts, and other special districts. Auto and equipment leases provide financing to both commercial entities as well as consumers. Dairy and livestock loans are loans to finance the operating needs of wholesale dairy farm operations, cattle feeders, livestock raisers, and farmers.

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Our loan portfolio is from a variety of areas throughout our marketplace. The following is the breakdown of our total loans and commercial real estate loans by region as of June 30, 2010.

June 30, 2010

| Non-Covered <br> Loans by Market Area | Total Non-Covered Loans |
| :--- | :---: | :---: | :---: | :---: | :---: |
| (amounts in |  |$\quad$| Non-Covered <br> Commercial <br> Real Estate Loans |  |  |  |
| :---: | :---: | :---: | :---: |
| Los Angeles County |  |  |  |

June 30, 2010
Covered Loans
Loans by Market Area
Los Angeles County
Inland Empire
Central Valley
Orange County
Other Areas (1)
(1) Other areas include church and hotel loans that are
out-of-state or
in other areas of
California
Of particular concern in the current credit and economic environments is our real estate and real estate construction loans. Our real estate loans are comprised of single-family residences, multifamily residences, industrial, office and retail. We strive to have a maximum loan-to-value ratio of $65-75 \%$. This table breaks down our real estate portfolio, with the exception of construction loans, which are discussed in greater detail below.

|  |  | June 30, 2010 <br> Percent <br> Owner- | Average <br> Loan |  |
| :--- | :---: | :---: | :---: | :---: |
| Non-Covered Real Estate Loans |  |  | Occupied | Balance |
| (amounts in thousands) | Loan | Balance | Percent | (1) |

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| Multifamily | 121,010 | $5.4 \%$ | $0.0 \%$ | 992 |
| :--- | ---: | ---: | ---: | ---: |
| Industrial | 644,817 | $28.6 \%$ | $36.8 \%$ | 864 |
| Office | 380,252 | $16.9 \%$ | $24.8 \%$ | 998 |
| Retail | 263,252 | $11.7 \%$ | $12.9 \%$ | 1,155 |
| Medical | 144,390 | $6.4 \%$ | $38.4 \%$ | 1,875 |
| Secured by Farmland | 160,278 | $7.1 \%$ | $100.0 \%$ | 2,137 |
| Other | 289,440 | $12.9 \%$ | $50.3 \%$ | 1,196 |
|  |  |  |  |  |
|  | $\$ 2,250,251$ | $100.0 \%$ | $44.5 \%$ | 1,070 |

(1) Represents percentage of owner-occupied in each real estate loan category

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In the table above, Single Family-Direct represents those single-family residence loans that we have made directly to our customers. These loans total $\$ 55.3$ million. In addition, we have purchased pools of owner-occupied single-family loans from real estate lenders, Single Family-Mortgage Pools, totaling $\$ 191.5$ million. These loans were purchased with FICO scores predominantly ranging from 700 to over 800 and original loan-to-value ratios of $60 \%$ to $80 \%$. These pools were purchased to diversify our loan portfolio since we make few single-family loans. Due to market conditions, we have not purchased any mortgage pools since August 2007.
The table below provides a breakdown of our covered real estate loans.
June 30, 2010

| Covered Real Estate Loans |  |  | Average <br> Loan |  |
| :--- | ---: | ---: | ---: | ---: |
| (amounts in thousands) | Loan <br> Balance | Percent | Balance |  |
| Single Family-Direct | $\$ 7,687$ | $2.4 \%$ | $\$$ | 296 |
| Multifamily | 20,688 | $6.4 \%$ | 643 |  |
| Industrial | 41,695 | $12.8 \%$ | 532 |  |
| Office | 31,151 | $9.6 \%$ | 554 |  |
| Retail | 39,939 | $12.3 \%$ | 401 |  |
| Medical | 28,268 | $8.7 \%$ | 646 |  |
| Secured by Farmland | 6,680 | $2.1 \%$ | 1,275 |  |
| Secured by Hotels | 61,594 | $18.8 \%$ | 3,623 |  |
| Church Loans | 45,640 | $14.0 \%$ | 1,755 |  |
| Other | 42,163 | $12.9 \%$ | 628 |  |
|  | $\$ 325,505$ | $100.0 \%$ | 1,154 |  |

As of June 30, 2010, the Company had $\$ 305.7$ million in construction loans. This represents $7.5 \%$ of gross loans outstanding of $\$ 4.1$ billion. The following table presents a break-down of our non-covered construction loans by county and type.

| Non-Covered |
| :--- |
| Construction Loans |
| (amounts in thousands) |
| Inland Empire |
| Los Angeles |
| Central Valley |
| San Diego |

Of this $\$ 185.2$ million in non-covered construction loans, approximately $11.1 \%$, or $\$ 20.6$ million, were for single-family residences, residential land loans, and multi-family land development loans. The remaining construction loans, totaling $\$ 164.6$ million, were related to commercial construction. The average balance of any single construction loan is approximately $\$ 3.4$ million. Our construction loans are located throughout our marketplace as can be seen in the table above. Of the total SFR and multifamily loans, one loan of $\$ 7.2$ million is a multifamily loan and the remainder represents single-family loans.

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The following table presents a break-down of our covered construction loans by county and type.

| Covered | June 30, 2010 |  |  |  |  |  |  |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
|  | SFR \& Multifamily |  |  |  |  |  |  |  |
| Construction Loans (amounts in thousands) | Land Development | Construction |  |  | Total |  |  |  |
| Central Valley | 43,221 | 83.2\% |  | 12,648 | 85.6\% |  | 55,869 | 83.8\% |
| Other (includes out-of-state) | 8,710 | 16.8\% |  | 2,120 | 14.4\% |  | 10,830 | 16.2\% |
|  | \$ 51,931 | 100.0\% | \$ | 14,768 | 100.0\% |  | 66,699 | 100.0\% |
|  | Commercial |  |  |  |  |  |  |  |
|  | Land Development |  | Con | ruction |  |  | Total |  |
|  | 13,537 | 100.0\% |  | 31,451 | 78.1\% |  | 44,988 | 83.6\% |
| Other (includes out-of-state) |  | 0.0\% |  | 8,800 | 21.9\% |  | 8,800 | 16.4\% |
|  | \$ 13,537 | 100.0\% | \$ | 40,251 | 100.0\% |  | 53,788 | 100.0\% |

## Allowance for Credit Losses

The allowance for credit losses was $\$ 118.5$ million as of June 30, 2010. This represents an increase of $\$ 9.6$ million, or $8.84 \%$, compared to allowance for credit losses of $\$ 108.9$ million as of December 31, 2009. Activity in the allowance for credit losses was as follows for the first six months of 2010 and for the year ended December 31, 2009.

|  | June 30, |  | December 31, |
| :--- | :---: | :---: | :---: |
| 2010 | 2009 |  |  |

## Non-performing Assets (Non-Covered)

We had non-covered non-performing assets of $\$ 97.9$ million at June 30, 2010. Non-performing assets represent $2.78 \%$ of total loans and OREO and $1.43 \%$ of total assets at June 30, 2010. We had non-performing assets of $\$ 73.7$ million at December 31, 2009. Non-performing assets include non-accrual loans plus other real estate owned (foreclosed property).

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## TABLE 5 Non-Performing Assets

(Non-Covered)

|  | $\begin{gathered} \text { June 30, } \\ 2010 \end{gathered}$ |  | $\begin{gathered} \text { December 31, } \\ 2009 \end{gathered}$ |  |
| :---: | :---: | :---: | :---: | :---: |
| Non-accrual loans | \$ | 62,265 | \$ | 68,762 |
| Restructured loans (non-performing) |  | 20,585 |  | 1,017 |
| Other real estate owned (OREO) |  | 15,001 |  | 3,936 |
| Total nonperforming assets | \$ | 97,851 | \$ | 73,715 |
| Restructured loans (performing) | \$ | 3,610 | \$ | 2,500 |
| Percentage of nonperforming assets to total loans outstanding \& OREO |  | 2.78\% |  | 2.04\% |
| Percentage of nonperforming assets to total assets |  | 1.43\% |  | 1.09\% |

We had loans with a balance of $\$ 86.5$ million classified as impaired at June 30, 2010. This balance includes the non-performing loans of $\$ 62.3$ million and loans which were restructured in a troubled debt restructuring with a balance of $\$ 24.2$ million as of June 30, 2010. At December 31, 2009, we had impaired loans with a balance of $\$ 72.3$ million. Impaired loans measured $2.26 \%$ of total non-covered loans as of June 30, 2010.
As of June 30, 2010, we had $\$ 15.0$ million in non-covered OREO compared to $\$ 3.9$ million as of December 31, 2009, an increase of $\$ 11.1$ million. This was primarily due to the sales of existing OREO properties of $\$ 1.5$ million, offset by the transfer of $\$ 12.6$ million from non-performing loans during the first six months of 2010. During the first six months of 2010, the Bank incurred expenses of $\$ 667,000$ related to the holding of OREO.
The table below provides trends in our non-covered non-performing assets and delinquencies over the past year.

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Non-Performing Assets \& Delinquency Trends
(Non-Covered Loans)

|  | $\begin{gathered} \text { June 30, } \\ 2010 \end{gathered}$ |  | $\begin{gathered} \text { March 31, } \\ 2010 \end{gathered}$ |  | $\begin{gathered} \text { December } \\ 31, \\ 2009 \end{gathered}$ |  | $\begin{gathered} \text { September } \\ 30, \\ 2009 \end{gathered}$ |  | June 30, 2009 |  |
| :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: | :---: |
| Non-Performing Loans |  |  |  |  |  |  |  |  |  |  |
| Residential Construction and |  |  |  |  |  |  |  |  |  |  |
| Land | \$ | 2,789 | \$ | 2,855 | \$ | 13,843 | \$ | 15,729 | \$ | 17,348 |
| Commercial Construction |  | 39,114 |  | 31,216 |  | 23,832 |  | 19,636 |  | 21,270 |
| Residential Mortgage |  | 12,638 |  | 13,726 |  | 11,787 |  | 8,102 |  | 4,632 |
| Commercial Real Estate |  | 20,639 |  | 22,041 |  | 17,129 |  | 13,522 |  | 7,041 |
| Commercial and Industrial |  | 7,527 |  | 6,879 |  | 3,173 |  | 1,045 |  | 859 |
| Consumer |  | 143 |  | 123 |  | 15 |  | 100 |  | 115 |
| Total | \$ | 82,850 | \$ | 76,840 | \$ | 69,779 | \$ | 58,134 | \$ | 51,265 |
| \% of Total Loans |  | 2.36\% |  | 2.19\% |  | 1.93\% |  | 1.61\% |  | 1.42\% |
| Past Due 30-89 Days |  |  |  |  |  |  |  |  |  |  |
| Residential Construction and |  |  |  |  |  |  |  |  |  |  |
| Land | \$ |  | \$ |  | \$ |  | \$ |  | \$ |  |
| Commercial Construction |  | 9,093 |  | 8,143 |  |  |  |  |  |  |
| Residential Mortgage |  | 2,552 |  | 3,746 |  | 4,921 |  | 1,510 |  | 2,069 |
| Commercial Real Estate |  | 1,966 |  | 3,286 |  | 2,407 |  | 190 |  | 1,074 |
| Commercial and Industrial |  | 634 |  | 2,714 |  | 2,973 |  | 5,094 |  | 590 |
| Dairy \& Livestock |  |  |  |  |  |  |  |  |  | 3,551 |
| Consumer |  | 139 |  | 28 |  | 239 |  | 87 |  | 8 |
| Total | \$ | 14,384 | \$ | 17,917 | \$ | 10,540 | \$ | 6,881 | \$ | 7,292 |
| \% of Total Loans |  | 0.41\% |  | 0.51\% |  | 0.29\% |  | 0.19\% |  | 0.20\% |
| OREO |  |  |  |  |  |  |  |  |  |  |
| Residential Construction and |  |  |  |  |  |  |  |  |  |  |
| Land | \$ | 11,113 | \$ | 11,113 | \$ |  | \$ | 1,137 | \$ | 1,789 |
| Commercial Construction |  |  |  |  |  |  |  |  |  |  |
| Commercial Real Estate |  | 3,220 |  | 3,746 |  | 3,936 |  |  |  | 1,187 |
| Commercial and Industrial |  | 668 |  |  |  |  |  |  |  | 893 |
| Residential Mortgage |  |  |  | 319 |  |  |  |  |  |  |
| Consumer |  |  |  |  |  |  |  |  |  | 166 |
| Total | \$ | 15,001 | \$ | 15,178 | \$ | 3,936 | \$ | 1,137 | \$ | 4,035 |
|  | \$ | 112,235 | \$ | 109,935 | \$ | 84,255 | \$ | 66,152 | \$ | 62,592 |

## Total Non-Performing, Past

Due \& OREO

| \% of Total Loans | $\mathbf{3 . 2 0 \%}$ | $\mathbf{3 . 1 3 \%}$ | $\mathbf{2 . 3 3 \%}$ | $\mathbf{1 . 8 4 \%}$ | $\mathbf{1 . 7 3 \%}$ |
| :--- | :--- | :--- | :--- | :--- | :--- |

We had $\$ 82.9$ million in non-covered non-performing loans at June 30, 2010, or $2.36 \%$ of total non-covered loans. This compares to $\$ 69.8$ million in non-performing loans at December 31, 2009 and $\$ 51.3$ million in non-performing loans at June 30, 2009. Non-performing loans consist of $\$ 2.8$ million in residential real estate construction and land loans, $\$ 39.1$ million in commercial construction loans, $\$ 12.7$ million in single-family mortgage loans, $\$ 20.7$ million in commercial real estate loans, $\$ 7.5$ million in other commercial loans and $\$ 0.1$ million in consumer loans.
The economic downturn has had an impact on our market area and on our loan portfolio. With the exception of assets discussed above, we are not aware of any other loans as of June 30, 2010 for which known credit problems of the borrower would cause serious doubts as to the ability of such borrowers to comply with their present loan repayment terms, or any known events that would result in the loan being designated as non-performing at some future date. We anticipate that there will be some additional losses in the loan portfolio given the current state of the economy. However, we cannot predict the extent to which the deterioration in general economic conditions, real estate values, increase in general rates of interest, change in the financial conditions or business of a borrower may adversely affect a borrower s ability to pay. See Risk Management Credit Risk herein.

## Deposits

The primary source of funds to support earning assets (loans and investments) is the generation of deposits from our customer base. The ability to grow the customer base and subsequently deposits is a crucial element in the performance of the Company.

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At June 30, 2010, total deposits were $\$ 4.60$ billion, representing an increase of $\$ 162.8$ million, or $3.67 \%$, over total deposits of $\$ 4.44$ billion at December 31, 2009. The composition of deposits is as follows:

June 30, 2010 December 31, 2009
(Amounts in thousands)

| Non-interest bearing deposits |  |  |  |  |
| :--- | ---: | ---: | ---: | ---: |
| Demand deposits | $\$ 1,646,717$ | $35.7 \%$ | $\$ 1,561,981$ | $35.2 \%$ |
| Interest bearing deposits | $1,755,569$ | $38.2 \%$ | $1,682,415$ | $37.9 \%$ |
| Savings Deposits | $1,199,204$ | $26.1 \%$ | $1,194,258$ | $26.9 \%$ |
| Time deposits | $\$ 4,601,490$ | $100.0 \%$ | $\$ 4,438,654$ | $100.0 \%$ |

The amount of non-interest-bearing demand deposits in relation to total deposits is an integral element in achieving a low cost of funds. Demand deposits totaled $\$ 1.65$ billion at June 30, 2010, representing an increase of $\$ 84.7$ million, or $5.42 \%$, over total demand deposits of $\$ 1.56$ billion at December 31, 2009. Non-interest-bearing demand deposits represented $35.7 \%$ of total deposits as of June 30, 2010 and $35.2 \%$ of total deposits as of December 31, 2009.
Savings deposits, which include savings, interest-bearing demand, and money market accounts, totaled $\$ 1.76$ billion at June 30, 2010, representing an increase of $\$ 73.2$ million, or $4.35 \%$, over savings deposits of $\$ 1.68$ billion at December 31, 2009.
Time deposits totaled $\$ 1.20$ billion at June 30, 2010. This represented an increase of $\$ 4.9$ million, or $0.41 \%$, over total time deposits of $\$ 1.19$ billion at December 31, 2009.

## Other Borrowed Funds

To achieve the desired growth in earning assets and to fully utilize our capital, we first pursue non-interest-bearing deposits (the lowest cost of funds to the Company). Next, we pursue interest-bearing deposits and finally we supplement the growth in deposits with borrowed funds. Average borrowed funds, as a percent of average total funding (total deposits plus demand notes plus borrowed funds) was $25.11 \%$ as of June 30, 2010, as compared to $31.23 \%$ as of December 31, 2009.
We enter into short-term borrowing agreements (borrowings with original maturities of one year or less) with the Federal Home Loan Bank (FHLB) and other institutions. The Bank had no outstanding balances under these agreements at June 30, 2010 and December 31, 2009. As a result of the increase in our deposits and customer repurchases, it was possible for us to reduce our reliance on borrowings.
In June 2006, the Company purchased securities totaling $\$ 250.0$ million. This purchase was funded by a repurchase agreement with J.P. Morgan of $\$ 250.0$ million, with a double cap embedded in the repurchase agreement. The interest rate on this agreement is fixed at $4.95 \%$ and the maturity is September 30, 2011. During the second quarter of 2010, we prepaid $\$ 100.0$ million of this structured repurchase agreement. The transaction resulted in a $\$ 5.7$ million prepayment charge recorded in other operating expense.
In November 2006, we began a repurchase agreement product with our customers. This product, known as Citizens Sweep Manager, sells our investment securities overnight to our customers under an agreement to repurchase them the next day. These repurchase agreements are with customers who have other banking relationships with us. As of June 30, 2010 and December 31, 2009, total customer repurchases were $\$ 595.7$ million and $\$ 485.1$ million, respectively, with weighted average annual interest rates of $0.77 \%$ and $0.95 \%$. As of June 30, 2010 and December 31, 2009 , total funds borrowed under these repurchase agreements were $\$ 745.7$ million and $\$ 735.1$ million, respectively. We also entered into long-term borrowing agreements (borrowings with original maturities of one year or longer) with the FHLB. We had outstanding balances of $\$ 650.0$ million and $\$ 750.0$ million under these agreements at June 30 , 2010 and December 31, 2009, respectively. The weighted average annual interest rate was $3.63 \%$ and $3.81 \%$ at June 30, 2010 and December 31, 2009, respectively. The FHLB holds certain investment securities and loans of the Bank as collateral for these borrowings.

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The Bank has an agreement, known as the Treasury Tax \& Loan ( TT\&L ) Note Option Program, with the Federal Reserve Bank and the U.S. Department of Treasury in which federal tax deposits made by depositors can be held by the bank until called (withdrawn) by the U.S. Department of Treasury. The maximum amount of accumulated federal tax deposits allowable to be held by the Bank, as set forth in the agreement, is $\$ 15.0$ million. On June 30, 2010 and December 31, 2009 the amounts held by the Bank in the TT\&L Note Option Program were $\$ 2.6$ million and $\$ 2.4$ million, collateralized by securities, respectively. Amounts are payable on demand.
At June 30, 2010, borrowed funds totaled $\$ 1.40$ billion, representing a decrease of $\$ 89.1$ million, or $5.98 \%$, from total borrowed funds of $\$ 1.49$ billion at December 31, 2009.

## Aggregate Contractual Obligations

The following table summarizes our contractual commitments as of June 30, 2010:

|  |  | $\begin{array}{c}\text { Less Than } \\ \text { One }\end{array}$ |  |  |  |  | $\begin{array}{c}\text { Maturity by Period } \\ \text { One Year } \\ \text { to Three } \\ \text { Four Year } \\ \text { to Five } \\ \text { Years }\end{array}$ |
| :--- | ---: | ---: | ---: | ---: | ---: | ---: | ---: |
|  | Total | $\begin{array}{c}\text { Year }\end{array}$ | $\begin{array}{c}\text { After } \\ \text { Five }\end{array}$ |  |  |  |  |
| Years |  |  |  |  |  |  |  |
| (amounts in thousands) |  |  |  |  |  |  |  |$]$

Deposits represent non-interest bearing, money market, savings, NOW, certificates of deposits, brokered and all other deposits held by the Company.
Repurchase agreements represent amounts due to customers, in addition to, the repurchase agreement with J.P. Morgan.
FHLB borrowings represent the amounts that are due to the Federal Home Loan Bank. These borrowings have fixed maturity dates. Other borrowings represent the amounts on FCB subordinated debt and TT\&L.
Junior subordinated debentures represent the amounts that are due from the Company to CVB Statutory Trust I, CVB Statutory Trust II \& CVB Statutory Trust III. The debentures have the same maturity as the Trust Preferred Securities. CVB Statutory Trust I, which matures in 2033, became callable in whole or in part in December 2008. CVB Statutory Trust II, which matures in 2034, became callable in whole or in part in January 2009. CVB Statutory Trust III, which matures in 2036, will become callable in whole or in part in 2011. It also represents FCB Capital Trust II which matures in 2033 and became callable in 2008. We have not called any of our debentures as of June 30, 2010.
Deferred compensation primarily represents the amounts that are due to former employees salary continuation agreements as a result of acquisitions.
Operating leases represent the total minimum lease payments under noncancelable operating leases.

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## Off-Balance Sheet Arrangements

At June 30, 2010, we had commitments to extend credit of approximately $\$ 573.3$ million and obligations under letters of credit of $\$ 68.3$ million and available lines of credit totaling $\$ 1.00$ billion from certain institutions. Commitments to extend credit are agreements to lend to customers, provided there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Commitments are generally variable rate, and many of these commitments are expected to expire without being drawn upon. As such, the total commitment amounts do not necessarily represent future cash requirements. The Bank uses the same credit underwriting policies in granting or accepting such commitments or contingent obligations as it does for on-balance-sheet instruments, which consist of evaluating customers creditworthiness individually. The Company has a reserve for undisbursed commitments of $\$ 9.6$ million as of June 30, 2010 and $\$ 7.9$ million as of December 31, 2009.
Standby letters of credit written are conditional commitments issued by the Bank to guarantee the financial performance of a customer to a third party. Those guarantees are primarily issued to support private borrowing arrangements. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. When deemed necessary, the Bank holds appropriate collateral supporting those commitments.
The following table summarizes the off-balance sheet arrangements at June 30, 2010:


## Liquidity and Cash Flow

Since the primary sources and uses of funds for the Bank are deposits and loans, the relationship between gross loans and total deposits provides a useful measure of the Bank s liquidity. Typically, the closer the ratio of loans to deposits is to $100 \%$, the more reliant the Bank is on its loan portfolio to provide for short-term liquidity needs. Since repayment of loans tends to be less predictable than the maturity of investments and other liquid resources, the higher the loan to deposit ratio the less liquid are the Bank s assets. For the first six months of 2010, the Bank s loan to deposit ratio averaged $88.08 \%$, compared to an average ratio of $97.98 \%$ for the same period in 2009. The Bank s ratio of loans to deposits and customer repurchases averaged $78.15 \%$ for the first six months of 2010 and $88.31 \%$ for the same period in 2009.
CVB is a company separate and apart from the Bank that must provide for its own liquidity and must service its own obligations. Substantially all of CVB s revenues are obtained from dividends declared and paid by the Bank. The remaining cash flow is from rents paid by third parties on office space in the Company s corporate headquarters. There are statutory and regulatory provisions that could limit the ability of the Bank to pay dividends to CVB. In addition, our regulators could limit the ability of the Bank or the Company to pay dividends or make other distributions. At June 30, 2010, approximately $\$ 108.7$ million of the Bank s equity was unrestricted and available to be paid as dividends to CVB. Management of CVB believes that such restrictions will not have an impact on the ability of CVB to meet its ongoing cash obligations.

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For the Bank, sources of funds normally include principal payments on loans and investments, other borrowed funds, and growth in deposits. Uses of funds include withdrawal of deposits, interest paid on deposits, increased loan balances, purchases, and other operating expenses.
Net cash provided by operating activities totaled $\$ 64.5$ million for the first six months of 2010, compared to $\$ 41.1$ million for the same period last year. The increase in cash provided by operating activities is primarily attributed to a decrease in interest paid on deposits and decrease in income taxes paid.
Net cash provided by investing activities totaled $\$ 275.7$ million for the first six months of 2010, compared to net cash provided by investing activities of $\$ 337.6$ million for the same period in 2009 . The cash provided by investing activities was primarily the result of a decrease in loans during the first six months of 2010, offset by purchases, repayments and maturities of investment securities.
Net cash provided by financing activities totaled $\$ 56.8$ million for the first six months of 2010, compared to net cash used in financing activities of $\$ 252.7$ million for the same period last year. The cash provided by financing activities during the first six months of 2010 was primarily due to an increase in deposits and customer repurchases, offset by repayment of advances from FHLB. The increase in cash used during the first six months of 2009 was primarily due to repayment of FHLB advances, offset by increases in deposits.
At June 30, 2010, cash and cash equivalents totaled $\$ 501.5$ million. This represented an increase of $\$ 280.3$ million, or $126.7 \%$, over a total of $\$ 221.2$ million at June 30, 2009 and an increase of $\$ 397.0$ million, or $380.01 \%$, over a total of $\$ 104.5$ million at December 31, 2009.

## Capital Resources

Historically, our primary source of capital has been the retention of operating earnings. In order to ensure adequate levels of capital, we conduct an ongoing assessment of projected sources, needs and uses of capital in conjunction with projected increases in assets and the level of risk. As part of this ongoing assessment, the Board of Directors reviews the various components of capital. Based on the Board of Directors analysis of our capital needs (including any capital needs arising out of our financial condition and results of operations or from any acquisitions we may make) and the input of our regulators, we could determine or, our regulators could require us, to raise additional capital.
The Bank and the Company are required to meet risk-based capital standards set by their respective regulatory authorities. The risk-based capital standards require the achievement of a minimum ratio of total capital to risk-weighted assets of $8.0 \%$ (of which at least $4.0 \%$ must be Tier 1 capital). In addition, the regulatory authorities require the highest rated institutions to maintain a minimum leverage ratio of $4.0 \%$. To be considered well-capitalized for bank regulatory purposes, the Bank and the Company are required to have a Tier 1 risk-based capital ratio equal to or greater than $6 \%$, a total risk-based capital ratio equal to or greater than $10 \%$ and a Tier 1 leverage ratio equal to or greater than $5 \%$. At June 30, 2010, the Bank and the Company exceeded the minimum risk-based capital ratios and leverage ratios required to be considered well-capitalized for regulatory purposes.
The Company s equity capital was $\$ 674.0$ million at June 30 , 2010. This represented an increase of $\$ 35.8$ million, or $5.60 \%$, over equity capital of $\$ 638.2$ million at December 31, 2009. The Company s 2009 Annual Report on Form 10-K (Management s Discussion and Analysis and Note 17 of the accompanying financial statements) describes the regulatory capital requirements of the Company and the Bank.

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During the first six months of 2010, the Board of Directors of the Company declared quarterly common stock cash dividends that totaled $\$ 0.17$ per share. Dividends are payable at the discretion of the Board of Directors and there can be no assurance that the Board of Directors will continue to pay dividends at the same rate, or at all, in the future. CVB s ability to pay cash dividends to its shareholders is subject to restrictions under federal and California law, including restrictions imposed by the FRB and covenants set forth in various agreements we are a party to including covenants set forth in our junior subordinated debentures.
The table below presents the Company s and the Bank s risk-based and leverage capital ratios as of June 30, 2010, and December 31, 2009.

## Capital Ratios

Risk-based capital ratios:
Tier I
Total
Leverage ratio
Tangible Capital Ratio

## Required Minimum Ratios

June 30, 2010

| $4.00 \%$ | $16.0 \%$ | $15.8 \%$ | $14.9 \%$ | $14.9 \%$ |
| ---: | ---: | ---: | ---: | ---: |
| $8.00 \%$ | $17.4 \%$ | $17.1 \%$ | $16.3 \%$ | $16.2 \%$ |
| $4.00 \%$ | $10.0 \%$ | $9.9 \%$ | $9.6 \%$ | $9.6 \%$ |
|  | $9.0 \%$ | $10.5 \%$ | $8.4 \%$ | $10.0 \%$ |

December 31, 2009
Company Bank

## RISK MANAGEMENT

We have adopted a Risk Management Plan to ensure the proper control and management of all risk factors inherent in the operation of the Company and the Bank. Specifically, credit risk, interest rate risk, liquidity risk, transaction risk, compliance risk, strategic risk, reputation risk, price risk and foreign exchange risk, can all affect the market risk exposure of the Company. These specific risk factors are not mutually exclusive. It is recognized that any product or service offered by us may expose the Bank to one or more of these risks. Our Risk Management Committee and Risk Management Department monitors these risks to minimize exposure to the Company.

## Credit Risk

Credit risk is defined as the risk to earnings or capital arising from an obligor s failure to meet the terms of any contract or otherwise fail to perform as agreed. Credit risk is found in all activities where success depends on counter party, issuer, or borrower performance. Credit risk arises through the extension of loans and leases, certain securities, and letters of credit.
Credit risk in the investment portfolio and correspondent bank accounts is addressed through defined limits in the Bank s policy statements. In addition, certain securities carry insurance to enhance credit quality of the bond. Limitations on industry concentration, aggregate customer borrowings, geographic boundaries and standards on loan quality also are designed to reduce loan credit risk. Senior Management, Directors Committees, and the Board of Directors are provided with information to appropriately identify, measure, control and monitor the credit risk of the Bank.
Implicit in lending activities is the risk that losses will occur and that the amount of such losses will vary over time. Consequently, we maintain an allowance for credit losses by charging a provision for credit losses to earnings. Loans determined to be losses are charged against the allowance for credit losses. Our allowance for credit losses is maintained at a level considered by us to be adequate to provide for estimated probable losses inherent in the existing portfolio.
The allowance for credit losses is based upon estimates of probable losses inherent in the loan and lease portfolio. The nature of the process by which we determine the appropriate allowance for credit losses requires the exercise of considerable judgment. The amount actually observed in respect of these losses can vary significantly from the estimated amounts. We employ a systematic methodology that is intended to reduce the differences between estimated and actual losses.

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Our methodology for assessing the appropriateness of the allowance is conducted on a regular basis and considers all loans. The systematic methodology consists of two major elements.
The first major element includes a detailed analysis of the loan portfolio in two phases. In the first phase, individual loans are reviewed to identify loans for impairment. A loan is impaired when principal and interest are deemed uncollectible in accordance with the original contractual terms of the loan. Impairment is measured as either the expected future cash flows discounted at each loan s effective interest rate, the fair value of the loan s collateral if the loan is collateral dependent, or an observable market price of the loan (if one exists). Upon measuring the impairment, we will ensure an appropriate level of allowance is present or established.
Central to the first phase of our credit risk management is its loan risk rating system. The originating credit officer assigns borrowers an initial risk rating, which is reviewed and possibly changed by Credit Management. The risk rating is based primarily on a thorough analysis of each borrower s financial capacity in conjunction with industry and economic trends. Credit approvals are made based upon the amount of inherent credit risk specific to the transaction and are reviewed for appropriateness by senior line and Credit Management personnel. Credits are monitored by line and Credit Management personnel for deterioration in a borrower $s$ financial condition, which would impact the ability of the borrower to perform under the contract. Risk ratings are adjusted as necessary.
Loans are risk rated into the following categories: Pass, Special Mention, Substandard, Doubtful, and Loss. Each of these groups is assessed and appropriate amounts used in determining the adequacy of our allowance for losses. The Impaired and Doubtful loans are analyzed on an individual basis for allowance amounts. The other categories have formulae used to determine the needed allowance amount.
The Bank obtains a quarterly independent credit review by engaging an outside party to review our loans. The primary purpose of this review is to evaluate our existing loan ratings and provide an assessment as to the effectiveness of our allowance process.
Based on the risk rating system, specific allowances are established in cases where we have identified significant conditions or circumstances related to a credit that we believe indicates the probability that a loss has been incurred. We perform a detailed analysis of these loans, including, but not limited to, cash flows, appraisals of the collateral, conditions of the marketplace for liquidating the collateral and assessment of the guarantors. We then determine the inherent loss potential and allocate a portion of the allowance for losses as a specific allowance for each of these credits.
The second phase is conducted by evaluating or segmenting the remainder of the loan portfolio into groups or pools of loans with similar characteristics in accordance with SFAS No. 5, Accounting for Contingencies. In this second phase, groups or pools of homogeneous loans are reviewed to determine a portfolio formula allowance. In the case of the portfolio formula allowance, homogeneous portfolios, such as small business loans, consumer loans, agricultural loans, and real estate loans, are aggregated or pooled in determining the appropriate allowance. The risk assessment process in this case emphasizes trends in the different portfolios for delinquency, loss, and other-behavioral characteristics of the subject portfolios.
The second major element in our methodology for assessing the appropriateness of the allowance consists of our considerations of all known relevant internal and external factors that may affect a loan s collectability. This includes our estimates of the amounts necessary for concentrations, economic uncertainties, the volatility of the market value of collateral, and other relevant factors. The relationship of the two major elements of the allowance to the total allowance may fluctuate from period to period.

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In the second major element of the analysis which considers all known relevant internal and external factors that may affect a loan s collectability, we perform an evaluation of various conditions, the effects of which are not directly measured in the determination of the formula and specific allowances. The evaluation of the inherent loss with respect to these conditions is subject to a higher degree of uncertainty because they are not identified with specific problem credits or portfolio segments. The conditions evaluated in connection with the second element of the analysis of the allowance include, but are not limited to the following conditions that existed as of the balance sheet date: then-existing general economic and business conditions affecting the key lending areas of the Company, then-existing economic and business conditions of areas outside the lending areas, such as other sections of the United States, Asia and Latin America,
credit quality trends (including trends in non-performing loans expected to result from existing conditions),
collateral values
loan volumes and concentrations,
seasoning of the loan portfolio,
specific industry conditions within portfolio segments,
recent loss experience in particular segments of the portfolio,
duration of the current business cycle,
bank regulatory examination results and
findings of the Company s external credit examiners.
We review these conditions in discussion with our senior credit officers. To the extent that any of these conditions is evidenced by a specifically identifiable problem credit or portfolio segment as of the evaluation date, our estimate of the effect of such condition may be reflected as a specific allowance applicable to such credit or portfolio segment. Where any of these conditions is not evidenced by a specifically identifiable problem credit or portfolio segment as of the evaluation date, our evaluation of the inherent loss related to such condition is reflected in the second major element of the allowance. Although we have allocated a portion of the allowance to specific loan categories, the adequacy of the allowance must be considered in its entirety.
Table 7 presents a comparison of net credit losses, the provision for credit losses (including adjustments incidental to mergers), and the resulting allowance for credit losses for the six months ended June 30, 2010 and 2009.

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|  | Six months 2010 <br> (amounts | ded June 30, 2009 <br> housands) |
| :---: | :---: | :---: |
| Amount of Total Loans at End of Period (1) | \$ 3,510,779 | \$ 3,614,756 |
| Average Total Loans Outstanding (1) | \$ 3,543,009 | \$ 3,667,152 |
| Allowance for Credit Losses: |  |  |
| Beginning of Period | \$ 108,924 | \$ 53,960 |
| Loans Charged-Off: |  |  |
| Construction Loans | 6,918 | 18,769 |
| Real Estate Loans | 2,964 | 495 |
| Commercial and Industrial | 3,741 | 2,264 |
| Lease Financing Receivables |  | 170 |
| Consumer Loans | 148 | 152 |
| Total Loans Charged-Off | 13,771 | 21,850 |
| Recoveries: |  |  |
| Real Estate Loans | 2 | 468 |
| Commercial and Industrial | 147 | 17 |
| Lease Financing Receivables |  | 147 |
| Consumer Loans | 46 | 13 |
| Total Loans Recovered | 195 | 645 |
| Net Loans Charged-Off | 13,576 | 21,205 |
| Provision Charged to Operating Expense | 23,200 | 42,000 |
| Allowance for Credit Losses at End of period | \$ 118,548 | \$ 74,755 |

## (1) Net of deferred

 loan fees| Net Loans Charged-Off to Average Total Loans | $0.38 \%$ |  |
| :--- | ---: | ---: |
| Net Loans Charged-Off to Total Loans at End of Period | $0.39 \%$ | $0.58 \%$ |
| Allowance for Credit Losses to Average Total Loans | $3.35 \%$ | $2.59 \%$ |
| Allowance for Credit Losses to Total Loans at End of Period | $3.38 \%$ | $2.04 \%$ |
| Net Loans Charged-Off to Allowance for Credit Losses | $11.45 \%$ | $28.37 \%$ |
| Net Loans Charged-Off to Provision for Credit Losses | $58.52 \%$ | $50.49 \%$ |

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While we believe that the allowance at June 30, 2010, was adequate to absorb losses from any known or inherent risks in the portfolio, no assurance can be given that economic conditions, conditions of our borrowers, or natural disasters which adversely affect the Company s service areas or other circumstances or conditions, including those identified above, will not be reflected in increased provisions or credit losses in the future.

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## ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

## Market Risk

In the normal course of our business activities, we are exposed to market risks, including price and liquidity risk. Market risk is the potential of loss from adverse changes in market rates and prices, such as interest rates (interest rate risk). Liquidity risk arises from the possibility that we may not be able to satisfy current or future commitments or that we may be more reliant on alternative funding sources such as long-term debt. Financial products that expose us to market risk include securities, loans, deposits, debts and derivative financial instruments.

## Counterparty Risk

Recent developments in the financial markets have placed an increased awareness of Counterparty Risks. These risks occur when a financial institution has an indebtedness or potential for indebtedness to another financial institution. We have assessed our Counterparty Risk at the end of the second quarter with the following results:

We have $\$ 150$ million in a repurchase agreement with an embedded double cap. This transaction was conducted in September 2006 to protect against rising interest rates. The repurchase agreement is with JP Morgan. The Moody s public debt rating for this institution is Aa3.
We do not have any investments in the preferred stock of any other company.
We do not have in our investment portfolio any trust preferred securities of any other company.
Most of our investments securities are either municipal securities or securities backed by mortgages, FNMA, FHLMC or FHLB.
All of our commercial line insurance policies are with companies with the highest AM Best ratings of AXII or above.
We have no significant Counterparty exposure related to derivatives such as interest rate swaps.
We have no significant exposure to our Cash Surrender Value of Life insurance since all of the insurance companies carry an AM Best rating of A or greater.
We have $\$ 295.0$ million in Fed Funds lines of credit with other banks. All of these banks are major U.S. banks, with over $\$ 20.0$ billion in assets. We rely on these funds for overnight borrowings. We currently have no outstanding Fed Funds balance.

## Interest Rate Risk

During periods of changing interest rates, the ability to reprice interest-earning assets and interest-bearing liabilities can influence net interest income, the net interest margin, and consequently, our earnings. Interest rate risk is managed by attempting to control the spread between rates earned on interest-earning assets and the rates paid on interest-bearing liabilities within the constraints imposed by market competition in the Bank s service area. Short-term repricing risk is minimized by controlling the level of floating rate loans and maintaining a downward sloping ladder of bond payments and maturities. Basis risk is managed by the timing and magnitude of changes to interest-bearing deposit rates. Yield curve risk is reduced by keeping the duration of the loan and bond portfolios balanced to attempt to minimize the risks of rising or falling yields. Options risk in the bond portfolio is monitored monthly and actions are recommended when appropriate.
We monitor the interest rate sensitivity risk to earnings from potential changes in interest rates using various methods, including a maturity/repricing gap analysis. This analysis measures, at specific time intervals, the differences between earning assets and interest-bearing liabilities for which repricing opportunities will occur. A positive difference, or gap, indicates that earning assets will reprice faster than interest-bearing liabilities. This will generally produce a greater net interest margin during periods of rising interest rates, and a lower net interest margin during periods of declining interest rates. Conversely, a negative gap indicates that interest-bearing liabilities will reprice faster than earning assets. This will generally produce a lower net interest margin during periods of rising interest rates and a greater net interest margin during periods of decreasing interest rates.

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The interest rates paid on deposit accounts do not always move in unison with the rates charged on loans. In addition, the magnitude of changes in the rates charged on loans is not always proportionate to the magnitude of changes in the rates paid for deposits. Consequently, changes in interest rates do not necessarily result in an increase or decrease in the net interest margin solely as a result of the differences between repricing opportunities of earning assets or interest-bearing liabilities. In general, whether we report a positive gap in the short-term period or negative gap in the long-term period does not necessarily indicate that, if interest rates decreased, net interest income would increase, or if interest rates increased, net interest income would decrease.
Approximately $\$ 1.1$ billion, or $56 \%$, of the total investment portfolio at June 30, 2010 consisted of securities backed by mortgages. The final maturity of these securities can be affected by the speed at which the underlying mortgages repay. Mortgages tend to repay faster as interest rates fall, and slower as interest rates rise. As a result, we may be subject to a prepayment risk resulting from greater funds available for reinvestment at a time when available yields are lower. Conversely, we may be subject to extension risk resulting from lesser amounts available for reinvestment at a time when available yields are higher. Prepayment risk includes the risk associated with the payment of an investment s principal faster than originally intended. Extension risk is the risk associated with the payment of an investment s principal over a longer time period than originally anticipated. In addition, there can be greater risk of price volatility for mortgage-backed securities as a result of anticipated prepayment or extension risk.
We also utilize the results of a dynamic simulation model to quantify the estimated exposure of net interest income to sustained interest rate changes. The sensitivity of our net interest income is measured over a rolling two-year horizon. The simulation model estimates the impact of changing interest rates on the interest income from all interest-earning assets and the interest expense paid on all interest-bearing liabilities reflected on the Company s balance sheet. This sensitivity analysis is compared to policy limits, which specify a maximum tolerance level for net interest income exposure over a one-year horizon assuming no balance sheet growth, given a 200 basis point upward and 100 basis point downward shift in interest rates. A parallel and pro rata shift in rates over a 12 -month period is assumed. The following depicts the Company s net interest income sensitivity analysis as of June 30, 2010:
Simulated
Rate Changes
+200 basis points
-100 basis points

## Estimated Net

Interest Income
Sensitivity +200 basis points (4.09\%) - 100 basis points 0.80\%

The Company is currently more liability sensitive. The estimated sensitivity does not necessarily represent our forecast and the results may not be indicative of actual changes to our net interest income. These estimates are based upon a number of assumptions including: the nature and timing of interest rate levels including yield curve shape, prepayments on loans and securities, pricing strategies on loans and deposits, and replacement of asset and liability cash flows. While the assumptions used are based on current economic and local market conditions, there is no assurance as to the predictive nature of these conditions including how customer preferences or competitor influences might change.

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## Liquidity Risk

Liquidity risk is the risk to earnings or capital resulting from our inability to meet our obligations when they come due without incurring unacceptable losses. It includes the ability to manage unplanned decreases or changes in funding sources and to recognize or address changes in market conditions that affect our ability to liquidate assets quickly and with minimum loss of value. Factors considered in liquidity risk management are stability of the deposit base; marketability, maturity, and pledging of investments; and the demand for credit.
In general, liquidity risk is managed daily by controlling the level of fed funds and the use of funds provided by the cash flow from the investment portfolio. To meet unexpected demands, lines of credit are maintained with correspondent banks, the Federal Home Loan Bank and the Federal Reserve Bank. The sale of bonds maturing in the near future can also serve as a contingent source of funds. Increases in deposit rates are considered a last resort as a means of raising funds to increase liquidity.

## Transaction Risk

Transaction risk is the risk to earnings or capital arising from problems in service or product delivery. This risk is significant within any bank and is interconnected with other risk categories in most activities throughout the Bank. Transaction risk is a function of internal controls, information systems, associate integrity, and operating processes. It arises daily throughout the Bank as transactions are processed. It pervades all divisions, departments and branches and is inherent in all products and services we offer.
In general, transaction risk is defined as high, medium or low by the internal auditors during the audit process. The audit plan ensures that high-risk areas are reviewed at least annually. We utilize a third party audit firm to provide internal audit services.
The key to monitoring transaction risk is in the design, documentation and implementation of well-defined procedures. All transaction related procedures include steps to report events that might increase transaction risk. Dual controls are also a form of monitoring.

## Compliance Risk

Compliance risk is the risk to earnings or capital arising from violations of, or non-conformance with, laws, rules, regulations, prescribed practices, or ethical standards. Compliance risk also arises in situations where the laws or rules governing certain Bank products or activities of the Bank s customers may be ambiguous or untested. Compliance risk exposes us to fines, civil money penalties, payment of damages, and the voiding of contracts. Compliance risk can also lead to a diminished reputation, reduced business value, limited business opportunities, lessened expansion potential, and lack of contract enforceability.
There is no single or primary source of compliance risk. It is inherent in every Bank activity. Frequently, it blends into operational risk and transaction processing. A portion of this risk is sometimes referred to as legal risk. This is not limited solely to risk from failure to comply with consumer protection laws; it encompasses all laws, as well as prudent ethical standards and contractual obligations. It also includes the exposure to litigation from all aspects of banking, traditional and non-traditional.
Our Risk Management Policy and Program and the Code of Ethical Conduct are the cornerstone for controlling compliance risk. An integral part of controlling this risk is the proper training of associates. The Chief Risk Officer is responsible for developing and executing a comprehensive compliance training program. The Chief Risk Officer will ensure that each associate receives adequate training with regard to their position to ensure that laws and regulations are not violated. All associates who deal in compliance high risk areas are trained to be knowledgeable about the level and severity of exposure in those areas and the policies and procedures in place to control such exposure.
Our Risk Management Policy and Program includes an audit program aimed at identifying problems and ensuring that problems are corrected. The audit program includes two levels of review. One is in-depth audits performed by an independent external firm and the other is periodic monitoring performed by the Risk Management Division.

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The Bank utilizes an independent external firm to conduct compliance audits as a means of identifying weaknesses in the compliance program itself. The independent external firm s audit plan includes a periodic review of each branch and department of the Bank.
The branch or department that is the subject of an audit is required to respond to the audit and correct any violations noted. The Chief Risk Officer will review audit findings and the response provided by the branch or department to identify areas which pose a significant compliance risk.
The Risk Management Division conducts periodic monitoring of our compliance efforts with a special focus on those areas that expose us to compliance risk. The purpose of the periodic monitoring is to ensure that our associates are adhering to established policies and procedures adopted by the Bank. The Chief Risk Officer will notify the appropriate department head and the Management Compliance Committee, the Audit Committee and the Risk Management Committee of any violations noted. The branch or department that is the subject of the review will be required to respond to the findings and correct any noted violations.
The Bank recognizes that customer complaints can often identify weaknesses in our compliance program which could expose the Bank to risk. Therefore, all complaints are given prompt attention. Our Risk Management Policy and Program includes provisions on how customer complaints are to be addressed. The Chief Risk Officer reviews all complaints to determine if a significant compliance risk exists and communicates those findings to the Risk Management Committee.

## Strategic Risk

Strategic risk is the risk to earnings or capital arising from adverse decisions or improper implementation of strategic decisions. This risk is a function of the compatibility between an organization s goals, the resources deployed against those goals and the quality of implementation.
Strategic risks are identified as part of the strategic planning process. Offsite strategic planning sessions are held annually. The strategic review consists of an economic assessment, competitive analysis, industry outlook and legislative and regulatory review.
A primary measurement of strategic risk is peer group analysis. Key performance ratios are compared to three separate peer groups to identify any sign of weakness and potential opportunities. The peer group consists of:

1. All banks of comparable size
2. High performing banks
3. A list of specific banks

Another measure is the comparison of the actual results of previous strategic initiatives against the expected results established prior to implementation of each strategy.
The corporate strategic plan is formally presented to all branch managers and department managers at an annual leadership conference.

## Reputation Risk

Reputation risk is the risk to capital and earnings arising from negative public opinion. This affects our ability to establish new relationships or services, or continue servicing existing relationships. It can expose us to litigation and, in some instances, financial loss.

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## Price and Foreign Exchange Risk

Price risk arises from changes in market factors that affect the value of traded instruments. Foreign exchange risk is the risk to earnings or capital arising from movements in foreign exchange rates.
Our current exposure to price risk is nominal. We do not have trading accounts. Consequently, the level of price risk within the investment portfolio is limited to the need to sell securities for reasons other than trading. The section of this policy pertaining to liquidity risk addresses this risk.
We maintain deposit accounts with various foreign banks. Our Interbank Liability Policy limits the balance in any of these accounts to an amount that does not present a significant risk to our earnings from changes in the value of foreign currencies.
Our asset liability model calculates the market value of the Bank s equity. In addition, management prepares on a monthly basis a Capital Volatility report that compares changes in the market value of the investment portfolio.
The Balance Sheet Management Policy requires the submission of a Fair Value Matrix Report to the Balance Sheet Management Committee on a quarterly basis. The report calculates the economic value of equity under different interest rate scenarios, revealing the level or price risk of the Bank s interest sensitive asset and liability portfolios.

## ITEM 4. CONTROLS AND PROCEDURES

As of the end of the period covered by this report, we carried out an evaluation of the effectiveness of the Company s disclosure controls and procedures under the supervision and with the participation of the Chief Executive Officer, the Chief Financial Officer and other senior management of the Company. Based on the foregoing, the Company s Chief Executive Officer and the Chief Financial Officer concluded that the Company s disclosure controls and procedures were effective as of the end of the period covered by this report.
During our most recent fiscal quarter, there have been no changes in our internal control over financial reporting that have materially affected or are reasonably likely to materially affect our internal control over financial reporting.

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## PART II OTHER INFORMATION

## ITEM 1. LEGAL PROCEEDINGS

On July 26, 2010, we received a subpoena from the Los Angeles office of the Securities and Exchange Commission. The subpoena and the SEC's corresponding investigation are non-public, which means that the information we provide to the SEC will not be publicized. We are, however, required to publicly disclose the fact that we received a subpoena from the SEC. The subpoena requests information regarding our loan underwriting guidelines, our allowance for credit losses and our allowance for loan loss calculation methodology, our methodology for grading loans and the process for making provisions for loan losses, and our provision for credit losses. In addition, the subpoena requests information regarding presentations we have given or conferences we have attended with analysts, brokers, investors or prospective investors.
We do not know the events that caused the SEC to request information on these subjects, and the SEC does not make this information known. According to the correspondence that accompanied the subpoena, " $[t]$ he investigation does not mean the [SEC has] concluded that you or anyone else has broken the law. Also, the investigation does not mean that we have a negative opinion of any person, entity or security."
CVB is fully complying with the SEC's requests, and we look forward to a speedy resolution.

## ITEM 1A. RISK FACTORS

Except as described below, there are no material changes to the risk factors as previously disclosed in our Annual Report on Form 10-K for the year ended December 31, 2009. The materialization of any risks and uncertainties identified in our Forward Looking Statements contained in this report together with those previously disclosed in the Form $10-\mathrm{K}$ and any subsequent Form $10-\mathrm{Q}$ or those that are presently unforeseen could result in significant adverse effects on our financial condition, results of operations and cash flows. See Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations General in this Quarterly Report on Form 10-Q. We are subject to a pending investigation by the Securities and Exchange Commission which could adversely affect us.
We are subject to an investigation by the SEC. We are unable, at this time, to estimate our potential liability in this matter, but may be required to pay judgments, settlements or other penalties and incur other costs and expenses in connection with this investigation which could have a material adverse effect on our business, results of operations and financial condition. In addition, responding to requests for information in this investigation may divert internal resources away from managing our business.
Implementation of the various provisions of the Dodd-Frank Act may increase our operating costs or otherwise have a material affect on our business, financial condition or results of operations.
On July 21, 2010, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act financial reform legislation. This landmark legislation includes, among other things, (i) the creation of a Financial Services Oversight Counsel to identify emerging systemic risks and improve interagency cooperation; (ii) the elimination of the Office of Thrift Supervision and the transfer of oversight of federally chartered thrift institutions and their holding companies to the Office of the Comptroller of the Currency and the Federal Reserve; (iii) the creation of a Consumer Financial Protection Agency authorized to promulgate and enforce consumer protection regulations relating to financial products that would affect banks and non-bank finance companies; (iv) the establishment of new capital and prudential standards for banks and bank holding companies, including the elimination of the ability to treat trust preferred securities as Tier 1 capital; (v) the termination of investments by the Treasury under the Troubled Assets Relief Program ( TARP ); (vi) enhanced regulation of financial markets, including the derivatives, securitization and mortgage origination markets; (vii) the elimination of certain proprietary trading and private equity investment activities by banks; (viii) the elimination of barriers to de novo interstate branching by banks; (ix) a permanent increase of the previously implemented temporary increase of FDIC deposit insurance to $\$ 250,000$; ( $x$ ) the authorization of interest-bearing transaction accounts and (xi) changes in the calculation of FDIC deposit insurance assessments will be calculated and an increase in the minimum designated reserve ratio for the Deposit Insurance Fund.

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Certain provisions of the legislation are not immediately effective or are subject to required studies and implementing regulations. Further, community banks with less than $\$ 10$ billion in assets (less than $\$ 15$ billion with respect to trust preferred securities) are exempt from certain provisions of the legislation. We cannot predict the how this significant new legislation may be interpreted and enforced or how implementing regulations and supervisory policies may affect us. There can be no assurance that these or future reforms will not significantly increase our compliance or operating costs or otherwise have a significant impact on our business, financial condition and results of operations.
ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS
We did not repurchase any common stock during the six months ended June 30, 2010. Our Board of Directors has authorized the repurchase of up to $10,000,000$ shares of our common stock, all of which remain to be repurchased at June 30, 2010.

## ITEM 3. DEFAULTS UPON SENIOR SECURITIES

Not Applicable
ITEM 4. REMOVED AND RESERVED
ITEM 5. OTHER INFORMATION

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## ITEM 6. EXHIBITS

Exhibit No. Description of Exhibits
3.1 Articles of Incorporation of the Company, as amended to date.
10.1 Summary CVB Financial Corp. Discretionary Performance Compensation Plan (1)
10.2 Executive Incentive Plan (2)
31.1 Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2 Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1 Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2 Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
(1) Incorporated by reference from Exhibit 10.1 to the Form 8-K filed by the Company on
April 2, 2010.
(2) Incorporated by reference from Annex A to the Definitive Proxy Statement filed by the Company on April 9, 2010.

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(3) SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

## CVB FINANCIAL CORP.

(Registrant)
Date: August 9, 2010
/s/ Edward J. Biebrich Jr.
Edward J. Biebrich Jr.
Duly Authorized Officer and Chief Financial Officer

