CENTRAL PACIFIC FINANCIAL CORP
Form 10-K/A
July 17, 2003

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

FORM 10-K/A

Amendment No. 1

Mark One

ý **Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

For the fiscal year ended December 31, 2002

or

o **Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

For the transition period from to .

Commission file number 0-10777

Central Pacific Financial Corp.

(Formerly CFB Inc.)

(Exact name of registrant as specified in its charter)

Hawaii	**99-0212597**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

220 South King Street, Honolulu, Hawaii	**96813**
(Address of principal executive offices)	(Zip Code)

Registrant s telephone number, including area code:
(808) 544-0500

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

Title of each class	**Name of each exchange on which registered**
Common Stock, No Par Value	New York Stock Exchange
Preferred Share Purchase Rights	New York Stock Exchange

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

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 ý No o

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 or Regulation S-K is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of the Form 10-K or any amendment to this Form 10-K. o

Indicate by check mark whether the registrant is an accelerated filer (as defined in Exchange Act Rule 12b-2). Yes ý No o

As of June 30, 2002, the aggregate market value of the common stock held by non-affiliates of the registrant was approximately $309,344,000.

As of February 28, 2003, the number of shares of common stock of the registrant outstanding was 16,006,748 shares.

The following documents are incorporated by reference herein:

Document Incorporated	**Part of Form 10-K Into Which Incorporated**
Definitive Proxy Statement for the Annual Meeting of Shareholders which was filed within 120 days of the fiscal year ended December 31, 2002	Part III

EXPLANATORY NOTE

This Amendment No. 1 to the Annual Report on Form 10-K for Central Pacific Financial Corp., formerly CPB Inc., (the Company) for the fiscal year ended December 31, 2002 as filed with the Securities and Exchange Commission on March 14, 2003 is being filed to amend the text of the Company s 10-K as follows:

to include additional disclosure related to the market area and recent trends under the caption Market Area and Competition in the Business section;

to include additional disclosure related to the risks related to loans under the caption Loan Portfolio in the Management s Discussion and Analysis section;

to explain the increase in commercial loans over year-end 2001 under the caption Loan Portfolio - Commercial, Financial and Agricultural in the Management s Discussion and Analysis section;

to include additional disclosure regarding risks related to loan losses and the related loan loss allowances under the caption Provision and Allowance for Loan Losses in the Management s Discussion and Analysis section and under Notes 1 and 5 to the Consolidated Financial Statements under the captions Allowance for Loan Losses ;

to correct the amounts reported for changes in the allowance for loan losses for impaired loans for 2002 under Note 5 to the Consolidated Financial Statements under the caption Allowance for Loan Losses ;

to include additional disclosure related to the consolidation practices under Note 1 to the Consolidated Financial Statements under the caption Principles of Consolidation ;

to include additional disclosure related to the FHLB advance under Note 9 to the Consolidated Financial Statements;

to include additional disclosure related to the segment information and the All others columns under Note 24 to the Consolidated Financial Statements; and

to include the city and state where the auditors report was issued in the Independent Auditors Report .

In addition, in connection with the filing of this Amendment and pursuant to the rules of the Securities and Exchange Commission, the Company is including with this Amendment certain currently dated certifications. The exhibit list to this Amendment is amended to reflect the previously filed exhibits to the Company s 10-K and, therefore, unless otherwise indicated those exhibits are not re-filed herewith. The remaining disclosures contained within this Amendment consist of all other disclosures originally contained in the Company s Annual Report on Form 10-K for the year ended December 31, 2002 in the form filed with the Securities and Exchange Commission on March 14, 2003. These other disclosures as originally included in the Company s 10-K are not amended hereby, but are included for the convenience of the reader. In order to preserve the nature and character of the disclosures set forth in such disclosures as originally filed, except as expressly noted herein, this report contains disclosures as of the date of the original filing, and the Company has not updated the disclosures in this report to reflect events subsequent to the original filing date, March 14, 2003. While this report primarily relates to the historical periods covered, events may have taken place since the original filing that might have been reflected in this report if they had taken place prior to the original filing date. All information contained in this Amendment may be updated or supplemented by disclosures contained in the Company s reports filed with the Securities and Exchange Commission subsequent to the date of the original filing of the Annual Report on Form 10-K, including but not limited to the Company s Quarterly Report on Form 10-Q for the three months ended March 31, 2003.

PART I

Forward-Looking Statements

This document may contain forward-looking statements concerning projections of revenues, income, earnings per share, capital expenditures, dividends, capital structure, or other financial items, concerning plans and objectives of management for future operations, concerning future economic performance, or concerning any of the assumptions underlying or relating to any of the foregoing. Forward-looking statements can be identified by the fact that they do not relate strictly to historical or current facts, and generally include the words believes , plans , intends , expects , anticipates or words of similar meaning. While we believe that our forward-looking statements and the assumptions underlying them are reasonably based, such statements and assumptions are by their nature subject to risks and uncertainties, and thus could later prove to be inaccurate or incorrect. Accordingly, actual results could materially differ from projections for a variety of reasons, to include, but not be limited to: the impact of local, national and international economies and events on CPB Inc. (the Company) business and operations and on tourism, the military, and other major industries operating within the Hawaii market; the impact of legislation affecting the banking industry; the impact of competitive products, services, pricing, and other competitive forces; movements in interest rates; loan delinquency rates; and trading of the Company s stock. For further information on factors that could cause actual results to materially differ from projections, please see the Company s publicly available Securities and Exchange Commission filings. Be advised the Company does not update any of its forward-looking statements.

ITEM 1. BUSINESS

General

The Company, a Hawaii corporation, is a bank holding company registered under the Bank Holding Company Act of 1956, as amended (the Bank Holding Company Act). Pursuant to a Plan of Reorganization and Agreement of Merger, the Company was organized on February 1, 1982 to serve as a holding company for its subsidiary, Central Pacific Bank (the Bank). The Bank was incorporated in its present form in the State of Hawaii on March 16, 1982 in connection with the holding company reorganization for the Company, and its predecessor entity was incorporated in the State of Hawaii on January 15, 1954. The Bank s deposits are insured by the Federal Deposit Insurance Corporation (FDIC) up to applicable limits. The Bank is not a member of the Federal Reserve System.

The Bank owns 100% of the outstanding stock of Central Business Club of Honolulu, Inc., whose principal business is the operation of a private food service facility.

The Bank also owns 99.8% and the Company owns 0.2% of the outstanding common stock of CPB Real Estate, Inc. (CPBREI), a real estate investment trust, which acquires, holds and manages stable, long-term real estate related assets including residential mortgage loans, commercial real estate loans and mortgage-backed securities. CPBREI, incorporated in March 1998, was established to provide the Company with an alternate means of raising capital and to enhance federal and state tax strategies. The impact of the tax strategies is discussed in note 17 to the Company s consolidated financial statements. In November 1998, CPBREI issued 1,000 shares of Class A preferred stock to the Bank and certain employees of the Bank. In September 2000, CPBREI issued 100 shares of Class B preferred stock to the Bank and 92 shares of Class C preferred stock to the Bank. In August 2001, the Bank sold 100 shares of Class B preferred stock of CPBREI to third party investors. At December 31, 2002, the Bank held 873 shares of CPBREI Class A preferred stock and 92 shares of CPBREI Class C preferred stock, and employees or former employees held 127 shares of CPBREI Class A preferred stock.

The Company s internet site can be found at www.cpbi.com. The Company s annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and all amendments to those reports can be found on the Company s internet site as soon as reasonably practicable after such material is electronically filed with or furnished to the Securities and Exchange Commission.

The principal office of the Company is located at 220 South King Street, Honolulu, Hawaii 96813, and its telephone number is (808) 544-0500.

Banking Services

The Bank is a full-service commercial bank that has 24 banking offices and 77 ATMs located throughout the State of Hawaii as of December 31, 2002. The Bank s administrative and main offices are located in Honolulu, and there are eighteen other branches on the island of Oahu. In addition, the Bank operates two branches on the island of Maui, one branch on the island of Kauai and two branches on the island of Hawaii.

Through its network of banking offices, the Bank emphasizes personalized services and offers a full range of banking services and products to small- and medium-sized businesses, professionals and individuals in Hawaii.

Market Area and Competition

The Bank competes in the financial services industry. The Hawaii market consists of five commercial banks, three savings and loans, one finance company and numerous credit unions.

Bancwest Corporation had $34.7 billion in assets at year-end 2002. First Hawaiian Bank, the Hawaii-based subsidiary bank, has approximately 24% of the deposits in the State of Hawaii.

Bank of Hawaii Corporation had $9.5 billion in total assets at year-end 2002. Bank of Hawaii, its largest subsidiary, maintains approximately 24% of the deposits in the State of Hawaii.

American Savings Bank, a subsidiary of Hawaiian Electric Industries, held $6.2 billion in assets at year-end 2002. American Savings Bank has approximately 16% of the deposits in the State of Hawaii.

Based on total consolidated assets at December 31, 2002, the Company is the third largest bank holding company in the State of Hawaii and the Bank is the third largest commercial bank in the state maintaining approximately 7% of the deposit market share. With $2.0 billion in assets, the Bank is establishing its position in the market as a local community bank that is large enough to provide a wide range of banking services, yet small enough to deliver personalized service. In order to compete with the other financial services providers in the State of Hawaii, the Bank principally relies upon local promotional activities, personal relationships established by officers, directors and employees with its customers, and specialized services tailored to meet the needs of the communities served. The Bank remains competitive with pricing and superior service levels. The Bank also has a strong capital base that can support expansion opportunities that may better serve the community.

The banking and financial services industry in the State of Hawaii generally, and in the Bank s target market areas, is highly competitive. The increasingly competitive environment is a result primarily of changes in regulation and changes in technology and product delivery systems. The Bank competes for loans, deposits and customers with other commercial banks, savings and loan associations, securities and brokerage companies, mortgage companies, insurance companies, finance companies, money market funds, credit unions and other nonbank financial service providers. Many of these competitors are much larger in total assets and capitalization, have greater access to capital markets and offer a broader range of financial services than the Bank. In addition, recent federal legislation may have the effect of further increasing the pace of consolidation within the financial services industry. See **ITEM 1. BUSINESS - Supervision and Regulation - Financial Services Modernization Legislation.**

At year-end 2002, personal income levels in Hawaii rose 2.8% above year-end 2001, similar to the growth rate for the entire United States for the comparable period. Also, Hawaii s population grew by 1.5% from a year ago, compared to an U.S. Census Bureau estimated 1.1% growth rate for the entire United States. The state s unemployment rate in December 2002 was 3.6%, an improvement over the 5.0% reported a year ago. The national unemployment rate was 5.7% at December 2002, compared to 5.4% at December 2001. The top five industries in the state, representing approximately 72% of total jobs, include: government, food service and accommodation, retail, healthcare, and professional services. The state s housing market, supported by low mortgage interest rates, continues to show strong growth. Residential home sales in 2002 were $2.6 billion, an increase of 31.1% over 2001. The 2002 median sales price for single family homes and condominiums increased by 11.7% and 14.3%, respectively. In 2002, the number of construction jobs grew by 3.9% and the number of building permits increased by 11.8% over the prior year. The state s tourism industry showed slight improvement over 2001. Total visitor arrivals were up 0.9% and total visitor days increased by 2.8%. Japanese visitor arrivals were down 4.3% in 2002, compared the 15.9% decrease reported in 2001.

Economic Conditions, Government Policies, Legislation, and Regulation

The Company s profitability, like most financial institutions, is primarily dependent on interest rate differentials. In general, the difference between the interest rates paid by the Bank on interest-bearing liabilities, such as deposits and other borrowings, and the interest rates received by the Bank on its interest-earning assets, such as loans extended to its clients and securities held in its investment portfolio, comprise the major portion of the Company s earnings. These rates are highly sensitive to many factors that are beyond the control of the

Company and the Bank, such as inflation, recession and unemployment, and the impact which future changes in domestic and foreign economic conditions might have on the Company and the Bank cannot be predicted.

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

From time to time, legislation, as well as regulations, are enacted which have the effect of increasing the cost of doing business, limiting or expanding permissible activities, or affecting the competitive balance between banks and other financial services providers. Proposals to change the laws and regulations governing the operations and taxation of banks, bank holding companies, and other financial institutions and financial services providers are frequently made in the U.S. Congress, in the state legislatures, and before various regulatory agencies. This legislation may change banking statutes and the operating environment of the Company and its subsidiaries in substantial and unpredictable ways. If enacted, such legislation could increase or decrease the cost of doing business, limit or expand permissible activities or affect the competitive balance among banks, savings associations, credit unions, and other financial institutions. The Company cannot predict whether any of this potential legislation will be enacted, and if enacted, the effect that it, or any implementing regulations, would have on the financial condition or results of operations of the Company or any of its subsidiaries. See **ITEM 1. BUSINESS - Supervision and Regulation.**

Supervision and Regulation

General

Bank holding companies and banks are extensively regulated under both federal and state law. This regulation is intended primarily for the protection of depositors and the deposit insurance fund and not for the benefit of shareholders of the Company. Set forth below is a summary description of the material laws and regulations which relate to the operations of the Company. The description is qualified in its entirety by reference to the applicable laws and regulations.

The Company

The Company is a registered bank holding company, and subject to regulation under the Bank Holding Company Act. The Company is required to file with the Federal Reserve Board periodic reports and such additional information as the Federal Reserve Board may require pursuant to the Bank Holding Company Act. The Federal Reserve Board may conduct examinations of the Company and its subsidiaries.

The Federal Reserve Board may require that the Company terminate an activity or terminate control of or liquidate or divest certain subsidiaries, affiliates or investments when the Federal Reserve Board believes the activity or the control of the subsidiary or affiliate constitutes a significant risk to the financial safety, soundness or stability of any of its banking subsidiaries. The Federal Reserve Board also has the authority to regulate provisions of certain bank holding company debt, including the authority to impose interest ceilings and reserve requirements on such debt. Under certain circumstances, the Company must file written notice and obtain approval from the Federal Reserve Board prior to purchasing or redeeming its equity securities.

Further, the Company is required by the Federal Reserve Board to maintain certain levels of capital. See **ITEM 1. BUSINESS Supervision and Regulation - Capital Standards.**

The Company is required to obtain the prior approval of the Federal Reserve Board for the acquisition of more than 5% of the outstanding shares of any class of voting securities or substantially all of the assets of any bank or bank holding company. Prior approval of the Federal Reserve Board is also required for the merger or consolidation of the Company and another bank holding company.

The Company is prohibited by the Bank Holding Company Act, except in certain statutorily prescribed instances, from acquiring direct or indirect ownership or control of more than 5% of the outstanding voting shares of any company that is not a bank or bank holding company and from engaging directly or indirectly in activities other than those of banking, managing or controlling banks, or furnishing services to its subsidiaries. However, the Company, subject to the prior approval of the Federal Reserve Board, may engage in any, or acquire shares of companies engaged in, activities that are deemed by the Federal Reserve Board to be so closely related to banking or managing or controlling banks as to be a proper incident thereto.

Under Federal Reserve Board regulations, a bank holding company is required to serve as a source of financial and managerial strength to its subsidiary banks and may not conduct its operations in an unsafe or unsound manner. In addition, it is the Federal Reserve Board s policy that a bank holding company should stand ready to use available resources to provide adequate capital funds to its subsidiary banks during periods of financial stress or adversity and should maintain the financial flexibility and capital-raising capacity to obtain additional resources for assisting its subsidiary banks. A bank holding company s failure to meet its obligations to serve as a source of strength to its subsidiary banks will generally be considered by the Federal Reserve Board to be an unsafe and unsound banking practice or a violation of the Federal Reserve Board s regulations or both.

The Company is also a financial institution holding company within the meaning of Section 412:1-109 of the Hawaii Revised Statutes. As such, the Company and its subsidiary are subject to examination by, and may be required to file reports with, the Hawaii Commissioner of Financial Institutions (the Commissioner).

The Company s securities are registered with the Securities and Exchange Commission under the Securities Exchange Act of 1934, as amended (the Exchange Act). As such, the Company is subject to the information, proxy solicitation, insider trading, corporate governance, and other requirements and restrictions of the Exchange Act.

The Bank

The Bank, as a Hawaii chartered bank, is subject to primary supervision, periodic examination, and regulation by the Commissioner and the FDIC. The Bank is also subject to certain regulations promulgated by the Federal Reserve Board. If, as a result of an examination of the Bank, the FDIC should determine that the financial condition, capital resources, asset quality, earnings prospects, management, liquidity, or other aspects of the Bank s operations are unsatisfactory or that the Bank or its management is violating or has violated any law or regulation, various remedies are available to the FDIC. Such remedies include the power to enjoin unsafe or unsound practices, to require affirmative action to correct any conditions resulting from any violation or practice, to issue an administrative order that can be judicially enforced, to direct an increase in capital, to restrict the growth of the Bank, to assess civil monetary penalties, to remove officers and directors, and ultimately to terminate the Bank s deposit insurance, which for a Hawaii chartered bank would result in a revocation of the Bank s charter. The Commissioner separately has many of the same remedial powers.

The Sarbanes-Oxley Act of 2002

On July 30, 2002, President Bush signed into law the Sarbanes-Oxley Act of 2002. This new legislation addresses accounting oversight and corporate governance matters, including:

the creation of a five-member oversight board appointed by the Securities & Exchange Commission that will set standards for accountants and have investigative and disciplinary powers;

the prohibition of accounting firms from providing various types of consulting services to public clients and requiring accounting firms to rotate partners among public client assignments every five years;

increased penalties for financial crimes;

expanded disclosure of corporate operations and internal controls and certification of financial statements;

enhanced controls on and reporting of insider trading; and

statutory separations between investment bankers and analysts.

We are currently evaluating what impacts the new legislation and its implementing regulations will have upon our operations, including a likely increase in certain outside professional costs.

USA Patriot Act of 2001

On October 26, 2001, President Bush signed the USA Patriot Act of 2001. The Patriot Act is intended is to strengthen the U.S. law enforcement and the intelligence communities abilities to work cohesively to combat terrorism on a variety of fronts. The potential impact of the Patriot Act on financial institutions of all kinds is significant and wide ranging. The Patriot Act contains sweeping anti-money laundering and financial transparency laws in addition to current requirements and requires various regulations, including:

due diligence requirements for financial institutions that administer, maintain, or manage private bank accounts or correspondent accounts for non-US persons;

standards for verifying customer identification at account opening;

rules to promote cooperation among financial institutions, regulators, and law enforcement entities in identifying parties that may be involved in terrorism or money laundering;

reports by non-financial businesses filed with the Treasury Department s Financial Crimes Enforcement Network for cash transactions exceeding $10,000; and

the filing of suspicious activities reports by securities brokers and dealers if they believe a customer may be violating U.S. laws and regulations.

On July 23, 2002, the U.S. Treasury proposed regulations requiring institutions to incorporate into their written money laundering plans a board approved customer identification program implementing reasonable procedures for:

verifying the identity of any person seeking to open an account, to the extent reasonable and practicable;

maintaining records of the information used to verify the person s identity; and

determining whether the person appears on any list of known or suspected terrorists or terrorist organizations.

Account is defined as a formal banking or business relationship established to provide ongoing services, dealings, or other financial transactions. The Company is not able to predict the impact of such law on its financial condition or results of operations at this time.

Financial Services Modernization Legislation

General. On November 12, 1999, President Clinton signed into law the Gramm-Leach-Bliley Act of 1999 (the GLBA), also known as the Financial Services Modernization Act of 1999. The general effect of the law is to establish a comprehensive framework to permit affiliations among commercial banks, insurance companies, securities firms, and other financial service providers by revising and expanding the Bank Holding Company Act framework to permit a holding company system to engage in a full range of financial activities through a new entity known as a financial holding company.

The law also:

broadened the activities that may be conducted by national banks, banking subsidiaries of bank holding companies, and their financial subsidiaries;

provided an enhanced framework for protecting the privacy of consumer information;

adopted a number of provisions related to the capitalization, membership, corporate governance, and other measures designed to modernize the Federal Home Loan Bank system;

modified the laws governing the implementation of the Community Reinvestment Act; and

addressed a variety of other legal and regulatory issues affecting both day-to-day operations and long-term activities of financial institutions.

The Company and the Bank do not believe that the GLBA will have a material adverse effect on operations in the near-term. However, to the extent that it permits banks, securities firms, and insurance companies to affiliate, the financial services industry may experience further consolidation. The GLBA is intended to grant to community banks certain powers as a matter of right that larger institutions have accumulated on an ad hoc basis. Nevertheless, this act may have the result of increasing the amount of competition that the Company and the Bank face from larger institutions and other types of companies offering financial products, many of which may have substantially more financial resources than the Company and the Bank.

Expanded Bank Activities. The GLBA also includes a new section of the Federal Deposit Insurance Act governing subsidiaries of state banks that engage in activities as principal that would only be permissible for a national bank to conduct in a financial subsidiary. It expressly preserves the ability of a state bank to retain all existing subsidiaries. Because the laws of the State of Hawaii do not permit the Bank to engage in all of the activities permissible to national banks, the Bank may be at a competitive disadvantage to national banks located in its market area that may offer such expanded financial products.

Privacy. Under the GLBA, federal banking regulators adopted rules that limit the ability of banks and other financial institutions to disclose non-public information about consumers to nonaffiliated third parties. Pursuant to these rules, effective July 1, 2001, financial institutions must provide:

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

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annual notices of their privacy policies to current customers; and

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

These privacy provisions affect how consumer information is transmitted through diversified financial companies and conveyed to outside vendors. Since the GLBA s enactment, a number of states have implemented their own versions of privacy laws. The Company has implemented its privacy policies in accordance with the law.

Dividends and Other Transfers of Funds

Dividends from the Bank constitute the principal source of income to the Company. The Company is a legal entity separate and distinct from the Bank. The Bank is subject to various statutory and regulatory restrictions on its ability to pay dividends to the Company. Under such restrictions, the amount available for payment of dividends to the Company by the Bank totaled $126.3 million at December 31, 2002. In addition, the Commissioner and the FDIC have the authority to prohibit the Bank from paying dividends, depending upon the Bank s financial condition, if such payment is deemed to constitute an unsafe or unsound practice. Compliance with the capital standards set forth by the FDIC or restrictions that are or may be imposed under the prompt corrective action provisions of federal law could limit the amount of dividends that the Bank or Company may pay. The Commissioner may impose similar limitations on the conduct of Hawaii-chartered banks. See **ITEM 1. BUSINESS Supervision and Regulation Capital Standards** and **ITEM 1. BUSINESS Supervision and Regulation Prompt Corrective Action and Other Enforcement Mechanisms** for further discussion of restrictions on capital distributions.

Transactions with Affiliates

The Bank is subject to certain restrictions imposed by federal law on any extensions of credit to, or the issuance of a guarantee or letter of credit on behalf of, the Company or other affiliates, the purchase of, or investments in, stock or other securities thereof, the taking of such securities as collateral for loans, and the purchase of assets of the Company or other affiliates. Such restrictions prevent the Company and such other affiliates from borrowing from the Bank unless the loans are secured by marketable obligations of designated amounts. Further, such secured loans and investments by the Bank to or in the Company or to or in any other affiliate are limited, individually, to 10.0% of the Bank s capital and surplus (as defined by federal regulations), and such secured loans and investments are limited, in the aggregate, to 20.0% of the Bank s capital and surplus (as defined by federal regulations). The State of Hawaii also imposes certain restrictions with respect to transactions involving the Company and other controlling persons of the Bank. Additional restrictions on transactions with affiliates may be imposed on the Bank under the prompt corrective action provisions of federal law. See **ITEM 1. BUSINESS - Supervision and Regulation - Prompt Corrective Action and Other Enforcement Mechanisms.**

Capital Standards

The federal banking agencies have adopted risk-based minimum capital guidelines intended to provide a measure of capital that reflects the degree of risk associated with a banking organization s operations for both transactions reported on the balance sheet as assets and transactions which are recorded as off balance sheet items. Under these guidelines, nominal dollar amounts of assets and credit equivalent amounts of off balance sheet items are multiplied by one of several risk adjustment percentages, which range from 0% for assets with low credit risk federal banking agencies, to 100% for assets with relatively high credit risk.

The guidelines require a minimum ratio of qualifying total capital to risk-adjusted assets of 8% and a minimum ratio of Tier 1 capital to risk-adjusted assets of 4%. In addition to the risk-based guidelines, federal banking regulators require banking organizations to maintain a minimum amount of Tier 1 capital to total assets, referred to as the leverage ratio. For a banking organization rated in the highest of the five categories used by regulators to rate banking organizations, the minimum leverage ratio of Tier 1 capital to total assets must be 3%. In addition to these uniform risk-based capital guidelines and leverage ratios that apply across the industry, the regulators have the discretion to set individual minimum capital requirements for specific institutions at rates significantly above the minimum guidelines and ratios. The Company s and Bank s capital ratios compared to the minimum regulatory capital requirements as of December 31, 2002 are discussed in note 25 to the Consolidated Financial Statements.

Predatory Lending

The term predatory lending, much like the terms safety and soundness and unfair and deceptive practices, is far-reaching and covers a potentially broad range of behavior. As such, it does not lend itself to a concise or a comprehensive definition. But typically predatory lending involves at least one, and perhaps all three, of the following elements:

making unaffordable loans based on the assets of the borrower rather than on the borrower s ability to repay an obligation (asset-based lending);

inducing a borrower to refinance a loan repeatedly in order to charge high points and fees each time the loan is refinanced (loan flipping); and

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

On October 1, 2002, the Federal Reserve Board regulations aimed at curbing such lending became effective. The rule significantly widens the pool of high-cost home-secured loans covered by the Home Ownership and Equity Protection Act of 1994, a federal law that requires extra disclosures and consumer protections to borrowers. The following triggers coverage under the act:

interest rates for first lien mortgage loans in excess of 8 percentage points above comparable Treasury securities;

subordinate-lien loans of 10 percentage points above Treasury securities; and

fees such as optional insurance and similar debt protection costs paid in connection with the credit transaction, when combined with points and fees if deemed excessive.

In addition, the regulation bars loan flipping by the same lender or loan servicer within a year. Lenders also will be presumed to have violated the law -- which says loans shouldn t be made to people unable to repay them - unless they document that the borrower has the ability to repay. Lenders that violate the rules face cancellation of loans and penalties equal to the finance charges paid.

The Bank is unable at this time to determine the impact of these rule changes and potential state action in this area on its financial condition or results of operation.

Prompt Corrective Action and Other Enforcement Mechanisms

Federal banking agencies possess broad powers to take corrective and other supervisory action to resolve the problems of insured depository institutions, including but not limited to those institutions that fall below one or more prescribed minimum capital ratios. Each federal banking agency has promulgated regulations defining the following five categories in which an insured depository institution will be placed, based on its capital ratios: well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized. At December 31, 2002, the Bank and the Company exceeded the required ratios for classification as well capitalized.

An institution that, based upon its capital levels, is classified as well capitalized, adequately capitalized, or undercapitalized may be treated as though it were in the next lower capital category if the appropriate federal banking agency, after notice and opportunity for hearing, determines that an unsafe or unsound condition or an unsafe or unsound practice warrants such treatment. At each successive lower capital category, an insured depository institution is subject to more restrictions. The federal banking agencies, however, may not treat a significantly undercapitalized institution as critically undercapitalized unless its capital ratio actually warrants such treatment.

In addition to measures taken under the prompt corrective action provisions, commercial banking organizations may be subject to potential enforcement actions by the federal regulators for unsafe or unsound practices in conducting their businesses or for violations of any law, rule, regulation, or any condition imposed in writing by the agency or any written agreement with the agency. Finally, pursuant to an interagency agreement, the FDIC can examine any institution that has a substandard regulatory examination score or is considered undercapitalized without the express permission of the institution s primary regulator.

Safety and Soundness Standards

The federal banking agencies have adopted guidelines designed to assist the federal banking agencies in identifying and addressing potential safety and soundness concerns before capital becomes impaired. The guidelines set forth operational and managerial standards relating to: (i) internal controls, information systems and internal audit systems, (ii) loan documentation, (iii) credit underwriting, (iv) asset growth, (v) earnings, and (vi) compensation, fees and benefits. In addition, the federal banking agencies have also adopted safety and soundness guidelines with respect to asset quality and earnings standards. These guidelines provide six standards for establishing and maintaining a system to identify problem assets and prevent those assets from deteriorating. Under these standards, an insured depository institution should: (i) conduct periodic asset quality reviews to identify problem assets, (ii) estimate the inherent losses in problem assets and establish reserves that are sufficient to absorb estimated losses, (iii) compare problem asset totals to capital, (iv) take appropriate corrective action to resolve problem assets, (v) consider the size and potential risks of material asset concentrations, and (vi) provide periodic asset quality reports with adequate information for management and the board of directors to assess the level of asset risk. These guidelines also set forth standards for evaluating and monitoring earnings and for ensuring that earnings are sufficient for the maintenance of adequate capital and reserves.

Premiums for Deposit Insurance

Through the Bank Insurance Fund (BIF), the FDIC insures the deposits of the Company s depository institution subsidiary up to prescribed limits for each depositor. The amount of FDIC assessments paid by each BIF member institution is based on its relative risk of default as measured by regulatory capital ratios and other factors. Specifically, the assessment rate is based on the institution s capitalization risk category and supervisory subgroup category. An institution s capitalization risk category is based on the FDIC s determination of whether the institution is well capitalized, adequately capitalized or less than adequately capitalized. An institution s supervisory subgroup category is based on the FDIC s assessment of the financial condition of the institution and the probability that FDIC intervention or other corrective action will be required.

FDIC-insured depository institutions pay an assessment rate equal to the rate assessed on deposits insured by the Savings Association Insurance Fund (SAIF).

The assessment rate currently ranges from zero to 27 cents per $100 of domestic deposits. The FDIC may increase or decrease the assessment rate schedule on a semi-annual basis. Due to continued growth in deposits and some recent bank failures, the BIF is nearing its minimum ratio of 1.25% of insured deposits as mandated by law. If the ratio drops below 1.25%, it is likely the FDIC will be required to assess premiums on all banks for the first time since 1996. Any increase in assessments or the assessment rate could have a material adverse effect on the Company s earnings, depending on the amount of the increase.

The FDIC is authorized to terminate a depository institution s deposit insurance upon a finding by the FDIC that the institution s financial condition is unsafe or unsound or that the institution has engaged in unsafe or unsound practices or has violated any applicable rule, regulation, order or condition enacted or imposed by the institution s regulatory agency. The termination of deposit insurance for one or more of the Company s subsidiary depository institutions could have a material adverse effect on the Company s earnings, depending on the collective size of the particular institutions involved.

All FDIC-insured depository institutions must pay an annual assessment to provide funds for the payment of interest on bonds issued by the Financing Corporation, a federal corporation chartered under the authority of the Federal Housing Finance Board. The bonds, commonly referred to as FICO bonds, were issued to capitalize the Federal Savings and Loan Insurance Corporation. The FDIC established the FICO assessment rates effective for the fourth quarter of 2002 at approximately $0.0170 per $100 of assessable deposits. The FICO assessments are adjusted quarterly to reflect changes in the assessment bases of the FDIC s insurance funds and do not vary depending on a depository institution s capitalization or supervisory evaluations.

Interstate Banking and Branching

The Bank Holding Company Act permits bank holding companies from any state to acquire banks and bank holding companies located in any other state, subject to certain conditions, including certain nationwide- and state-imposed concentration limits. The Bank has the ability, subject to certain State restrictions, to acquire by acquisition or merger branches outside its home state. The establishment of new interstate branches is also possible in those states with laws that expressly permit it. Interstate branches are subject to certain laws of the states in which they are located. Competition may increase further as banks branch across state lines and enter new markets.

Community Reinvestment Act and Fair Lending Developments

The Bank is subject to certain fair lending requirements and reporting obligations involving home mortgage lending operations and Community Reinvestment Act activities. The Community Reinvestment Act generally requires the federal banking agencies to evaluate the record of a financial institution in meeting the credit needs of its local communities, including low- and moderate-income neighborhoods. A bank may be subject to substantial penalties and corrective measures for a violation of certain fair lending laws. The federal banking agencies may take compliance with such laws and Community Reinvestment Act obligations into account when regulating and supervising other activities. Furthermore, financial institutions are subject to annual reporting and public disclosure requirements for certain written agreements that are entered into between insured depository institutions or their affiliates and nongovernmental entities or persons that are made pursuant to, or in connection with, the fulfillment of the Community Reinvestment Act.

A bank s compliance with its Community Reinvestment Act obligations is based on a performance-based evaluation system which bases Community Reinvestment Act ratings on an institution s lending service and investment performance. When a bank holding company applies for approval to acquire a bank or other bank holding company, the Federal Reserve Board will review the assessment of each subsidiary bank of the applicant bank holding company, and such records may be the basis for denying the application. Based on an examination conducted August 23, 2002, the Bank was received asatisfactory rating.

Federal Reserve System

The Federal Reserve Board requires all depository institutions to maintain non-interest bearing reserves at specified levels against their transaction accounts (primarily checking, NOW,