

FIRST PACTRUST BANCORP INC

Form 10-K

March 10, 2008

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# SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

## FORM 10-K

FOR ANNUAL AND TRANSITION REPORTS

PURSUANT TO SECTIONS 13 OR 15(d) OF THE

SECURITIES EXCHANGE ACT OF 1934

x ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2007

.. 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 000-49806

**FIRST PACTRUST BANCORP, INC.**

(Exact name of registrant as specified in its charter)

|   |  |
|---|--|
| <b>Maryland</b><br>(State or other jurisdiction of<br>incorporation or organization)          | <b>04-3639825</b><br>(I.R.S. Employer<br>Identification No.) |
| <b>610 Bay Boulevard, Chula Vista, California</b><br>(Address of Principal Executive Offices) | <b>91910</b><br>(Zip Code)                                   |
| <b>Registrant's telephone number, including area code: (619) 691-1519</b>                     |  |

**Securities Registered Pursuant to Section 12(b) of the Act:**

**Common Stock, par value \$0.01 per share**

(Title of class)

**Securities Registered Pursuant to Section 12(g) of the Act:**

**None**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. YES  NO

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

Check whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the past 12 months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days. YES  NO

Check if there is no disclosure of delinquent filers in response to Item 405 of Regulation S-K contained herein, and no disclosure will be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definition of "accelerated filer," "large accelerated filer," and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check One):

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company

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

The aggregate market value of the voting stock held by non-affiliates of the registrant, computed by reference to the closing price of such stock on the Nasdaq System as of June 30, 2007, was \$68.4 million. (The exclusion from such amount of the market value of the shares owned by any person shall not be deemed an admission by the registrant that such person is an affiliate of the registrant.) As of March 7, 2008, there were issued and outstanding 4,372,238 shares of the Registrant's Common Stock.

**DOCUMENTS INCORPORATED BY REFERENCE**

PART III of Form 10-K Portions of the Proxy Statement for the Annual Meeting of Shareholders to be held during April 2008.

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**FIRST PACTRUST BANCORP, INC. AND SUBSIDIARIES**

**FORM 10-K**

**December 31, 2007**

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**PART I**

**Item 1. Business**

**General**

First PacTrust Bancorp, Inc. ( the Company ) was incorporated under Maryland law in March 2002 to hold all of the stock of Pacific Trust Bank ( the Bank ). Maryland was chosen as the state of incorporation because it provides protections similar to Delaware with respect to takeover, indemnification and limitations on liability, with reduced franchise taxes. First PacTrust Bancorp, Inc. is a savings and loan holding company and is subject to regulation by the Office of Thrift Supervision. First PacTrust Bancorp, Inc. is a unitary thrift holding company, which means that it owns one thrift institution. As a thrift holding company, First PacTrust Bancorp, Inc., activities are limited to banking, securities, insurance and financial services-related activities. See How We Are Regulated First PacTrust Bancorp, Inc. First PacTrust Bancorp, Inc. is not an operating company and has no significant assets other than all of the outstanding shares of common stock of Pacific Trust Bank, the net proceeds retained from its initial public offering completed in August 2002, and its loan to the First PacTrust Bancorp, Inc. 401(k) Employee Stock Ownership Plan. First PacTrust Bancorp, Inc. has no significant liabilities. The management of the Company and the Bank is substantially the same. The Company utilizes the support staff and offices of the Bank and pays the Bank for these services. If the Company expands or changes its business in the future, the Company may hire the Company s own employees. Unless the context otherwise requires, all references to the Company include the Bank and the Company on a consolidated basis.

The Company is a community-oriented financial institution offering a variety of financial services to meet the needs of the communities we serve. The Company is headquartered in Chula Vista, California, a suburb of San Diego, California and has nine banking offices primarily serving San Diego and Riverside Counties in California. Our geographic market for loans and deposits is principally San Diego and Riverside counties.

The principal business consists of attracting retail deposits from the general public and investing these funds primarily in permanent loans secured by first mortgages on owner-occupied, one-to four- family residences and a variety of consumer loans. The Company also originates loans secured by multi-family and commercial real estate and, to a limited extent, commercial business loans.

The Company offers a variety of deposit accounts having a wide range of interest rates and terms, which generally include savings accounts, money market deposits, certificate accounts and checking accounts. The Company solicits deposits in the Company s market area and, to a lesser extent from institutional depositors nationwide, and has accepted brokered deposits.

The principal executive offices of First PacTrust Bancorp, Inc. are located at 610 Bay Boulevard, Chula Vista, California, and its telephone number is (619) 691-1519.

The Company s reports, proxy statements and other information the Company files with the SEC, as well as news releases, are available free of charge through the Company s Internet site at <http://www.firstpactrustbancorp.com>. This information can be found on the First PacTrust Bancorp, Inc. News or SEC Filings pages of our Internet site. The annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports filed and furnished pursuant to Section 13(a) of the Exchange Act are available as soon as reasonably practicable after they have been filed with the SEC. Reference to the Company s Internet address is not intended to incorporate any of the information contained on our Internet site into this document.

**Forward-Looking Statements**

This Form 10-K contains various forward-looking statements that are based on assumptions and describe our future plans and strategies and our expectations. These forward-looking statements are generally identified

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by words such as believe, expect, intend, anticipate, estimate, project, or similar words. Our ability to predict results or the actual effect of our plans or strategies is uncertain. Factors which could cause actual results to differ materially from those estimated include, but are not limited to, changes in interest rates, general economic conditions, legislative/regulatory changes, monetary and fiscal policies of the U.S. Government, including policies of the U.S. Treasury and the Federal Reserve Board, the quality and composition of our loan and investment portfolios, demand for our loan products, deposit flows, our operating expenses, competition, demand for financial services in our market areas and accounting principles and guidelines. These risks and uncertainties should be considered in evaluating forward-looking statements, and you should not rely too much on these statements. We do not undertake, and specifically disclaim, any obligation to publicly revise any forward-looking statements to reflect events or circumstances after the date of such statements or to reflect the occurrence of anticipated or unanticipated events.

## **Lending Activities**

**General.** The Company's mortgage loans carry either a fixed or an adjustable rate of interest. Mortgage loans generally are long-term and amortize on a monthly basis with principal and interest due each month. The Company also has loans in the portfolio which require only interest payments on a monthly basis or may have the potential for negative amortization. At December 31, 2007, the Company had a total of \$294.3 million in interest only mortgage loans and \$48.2 million in mortgage loans with potential for negative amortization. In 2005, the Company introduced a new lending product called the Green Account. This product is America's first fully-transactional flexible mortgage account. The Green account is a first mortgage line of credit with an associated clearing account that allows all types of deposits and withdrawals to be performed, including direct deposit, check, debit card, ATM, ACH debits and credits, and internet banking and bill payment transactions. At December 31, 2007, the balance of the Company's Green account loans totaled \$164.0 million. For further detailed information on this product, visit the Company's website at [www.pacifictrustbank.com](http://www.pacifictrustbank.com). At December 31, 2007, the Company's net loan portfolio totaled \$710.6 million, which constituted 91.7% of our total assets.

Senior loan officers may approve loans to one borrower or group of related borrowers up to \$1.5 million. The Executive Vice President of Lending may approve loans to one borrower or group of related borrowers up to \$2.0 million. The President/CEO may approve loans to one borrower or group of related borrowers up to \$2.5 million. The Management Loan Committee may approve loans to one borrower or group of related borrowers up to \$8.0 million, with no single loan exceeding \$4.0 million. The Board Loan Committee must approve loans over these amounts or outside our general loan policy.

At December 31, 2007, the maximum amount which the Company could have loaned to any one borrower and the borrower's related entities, was approximately \$12.3 million. The largest lending relationship to a single borrower or a group of related borrowers was a combination of commercial real estate, multi-family and single family loans totaling an aggregate amount of \$12.5 million. At the time of origination, the total exposure was within the bank's maximum loan to one borrower amount which has since declined primarily due to a reduction of capital. The properties securing these loans are located in Anaheim and San Diego, California. These loans were current as of December 31, 2007 and have never been delinquent.

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The following table presents information concerning the composition of the Company's loan portfolio in dollar amounts and in percentages as of the dates indicated.

|                                     | 2007       |         | 2006       |         | December 31,<br>2005 |         | 2004       |         | 2003       |         |
|-------------------------------------|------------|---------|------------|---------|----------------------|---------|------------|---------|------------|---------|
|                                     | Amount     | Percent | Amount     | Percent | Amount               | Percent | Amount     | Percent | Amount     | Percent |
| (Dollars in Thousands)              |            |         |            |         |                      |         |            |         |            |         |
| <b>Real Estate</b>                  |            |         |            |         |                      |         |            |         |            |         |
| One- to four-family                 | \$ 421,064 | 58.96%  | \$ 515,891 | 69.46%  | \$ 559,193           | 80.87%  | \$ 517,564 | 81.90%  | \$ 496,253 | 84.07%  |
| Commercial and multi-family         | 94,544     | 13.24   | 106,310    | 14.31   | 96,650               | 13.98   | 96,655     | 15.29   | 75,386     | 12.77   |
| Construction                        | 18,866     | 2.64    | 16,409     | 2.21    | 6,424                | 0.93    | 126        | 0.02    | 2,229      | 0.38    |
| <b>Consumer:</b>                    |            |         |            |         |                      |         |            |         |            |         |
| Home equity-real estate secured*    | 175,702    | 24.60   | 100,545    | 13.54   | 25,550               | 3.69    | 12,905     | 2.04    | 10,738     | 1.82    |
| Automobile                          | 430        | 0.06    | 589        | 0.08    | 820                  | 0.12    | 1,274      | 0.20    | 2,202      | 0.37    |
| Other                               | 2,123      | 0.30    | 2,355      | 0.32    | 2,196                | 0.32    | 2,746      | 0.44    | 2,706      | 0.46    |
| Commercial                          | 1,398      | 0.20    | 611        | 0.08    | 622                  | 0.09    | 681        | 0.11    | 752        | 0.13    |
| Total loans                         | 714,127    | 100.00% | 742,710    | 100.00% | 691,455              | 100.00% | 631,951    | 100.00% | 590,266    | 100.00% |
| Net deferred loan origination costs | 2,208      |         | 2,004      |         | 1,733                |         | 1,203      |         | 1,217      |         |
| Allowance for loan losses           | (6,240)    |         | (4,670)    |         | (4,691)              |         | (4,430)    |         | (4,232)    |         |
| Total loans receivable, net         | \$ 710,095 |         | \$ 740,044 |         | \$ 688,497           |         | \$ 628,724 |         | \$ 587,251 |         |

\* At 12/31/07, this total includes \$164.0 million of the Company's Green account loans, of which \$155.0 million is secured by one-to-four family properties, \$6.2 million is secured by commercial properties, \$2.3 million is secured by multi-family properties and \$429 thousand is secured by land. At 12/31/06, this total included \$87.3 million of the Company's Green account loans, of which \$84.4 million was secured by one-to four- family properties, \$1.3 million was secured by multi-family properties and \$1.7 million was secured by commercial properties. At 12/31/05, this total included \$9.7 million of the Company's Green account loans all of which were secured by one-to four-family properties.

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The following table shows the composition of the Company's loan portfolio by fixed- and adjustable-rate at the dates indicated.

|                                     | 2007       |         | 2006       |         | December 31,<br>2005 |         | 2004       |         | 2003       |         |
|-------------------------------------|------------|---------|------------|---------|----------------------|---------|------------|---------|------------|---------|
|                                     | Amount     | Percent | Amount     | Percent | Amount               | Percent | Amount     | Percent | Amount     | Percent |
| <b>FIXED-RATE LOANS</b>             |            |         |            |         |                      |         |            |         |            |         |
| <u>Real Estate</u>                  |            |         |            |         |                      |         |            |         |            |         |
| One- to four-family                 | \$ 10,440  | 1.46%   | \$ 10,750  | 1.45%   | \$ 13,061            | 1.89%   | \$ 14,762  | 2.34%   | \$ 54,339  | 9.21%   |
| Commercial and multi-family         | 70,061     | 9.81    | 67,444     | 9.08    | 47,253               | 6.83    | 33,684     | 5.33    | 3,884      | 0.66    |
| Construction                        |            |         |            |         |                      |         |            |         |            |         |
| <u>Other loans</u>                  |            |         |            |         |                      |         |            |         |            |         |
| Consumer:                           |            |         |            |         |                      |         |            |         |            |         |
| Automobile                          | 420        | .06     | 546        | .07     | 721                  | 0.10    | 1,003      | 0.16    | 1,727      | 0.29    |
| Home equity-real estate secured     | 429        | .06     |            |         |                      |         |            |         |            |         |
| Other                               | 448        | .06     | 381        | .05     | 369                  | 0.05    | 401        | 0.06    | 725        | 0.12    |
| Commercial                          | 500        | .07     |            |         | 65                   | 0.01    | 87         | 0.01    | 192        | 0.03    |
| Total fixed-rate loans              | 82,298     | 11.52   | 79,121     | 10.65   | 61,469               | 8.88    | 49,937     | 7.90    | 60,867     | 10.31   |
| <b>ADJUSTABLE-RATE</b>              |            |         |            |         |                      |         |            |         |            |         |
| <u>Real Estate</u>                  |            |         |            |         |                      |         |            |         |            |         |
| One- to four-family                 | 410,624    | 57.50   | 505,141    | 68.01   | 546,132              | 78.98   | 502,802    | 79.56   | 441,914    | 74.87   |
| Commercial and multi-family         | 24,483     | 3.43    | 38,866     | 5.23    | 49,397               | 7.15    | 62,971     | 9.97    | 71,502     | 12.11   |
| Construction                        | 18,866     | 2.64    | 16,409     | 2.21    | 6,424                | 0.93    | 126        | 0.02    | 2,229      | 0.38    |
| <u>Other loans</u>                  |            |         |            |         |                      |         |            |         |            |         |
| Consumer:                           |            |         |            |         |                      |         |            |         |            |         |
| Automobile                          | 10         | .00     | 43         | .01     | 99                   | 0.01    | 271        | 0.04    | 475        | 0.08    |
| Home equity-real estate secured     | 175,273    | 24.54   | 100,545    | 13.54   | 25,550               | 3.70    | 12,905     | 2.04    | 10,738     | 1.82    |
| Other                               | 1,675      | .24     | 1,974      | .27     | 1,827                | 0.27    | 2,345      | 0.37    | 1,981      | 0.34    |
| Commercial                          | 898        | .13     | 611        | .08     | 557                  | 0.08    | 594        | 0.10    | 560        | 0.09    |
| Total adjustable-rate loans         | 631,829    | 88.48   | 663,589    | 89.35   | 629,986              | 91.12   | 582,014    | 92.10   | 529,399    | 89.69   |
| Total loans                         | 714,127    | 100.00% | 742,710    | 100.00% | 691,455              | 100.00% | 631,951    | 100.00% | 590,266    | 100.00% |
| Net deferred loan origination costs | 2,208      |         | 2,004      |         | 1,733                |         | 1,203      |         | 1,217      |         |
| Allowance for loan losses           | (6,240)    |         | (4,670)    |         | (4,691)              |         | (4,430)    |         | (4,232)    |         |
| Total loans receivable, net         | \$ 710,095 |         | \$ 740,044 |         | \$ 688,497           |         | \$ 628,724 |         | \$ 587,251 |         |



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The following schedule illustrates the contractual maturity of the Company's loan portfolio at December 31, 2007.

| Due During Years Ending<br>December 31, | One- to Four-Family |                             | Real Estate<br>Multi-family and<br>Commercial and Land |                             | Construction |                             | Consumer   |                             | Commercial<br>Business |                             | Total<br>Amount | Weighted<br>Average<br>Rate |
|---|---------------------|-----------------------------|--|-----------------------------|--------------|-----------------------------|------------|-----------------------------|------------------------|-----------------------------|-----------------|-----------------------------|
|   | Amount              | Weighted<br>Average<br>Rate | Amount   | Weighted<br>Average<br>Rate | Amount       | Weighted<br>Average<br>Rate | Amount     | Weighted<br>Average<br>Rate | Amount                 | Weighted<br>Average<br>Rate |                 |                             |
| (Dollars in Thousands)                  |                     |                             |  |                             |              |                             |            |                             |                        |                             |                 |                             |
| 2008(1)                                 | \$ 4,881            | 5.16%                       | \$ 26,768  | 8.16%                       | \$ 18,866    | 9.42%                       | \$ 2,884   | 10.12%                      | \$ 597                 | 12.22%                      | \$ 53,996       | 8.48%                       |
| 2009                                    | 1,681               | 7.06                        | 1,557  | 7.29                        |              |                             | 181        | 7.19                        |                        |                             | 3,419           | 7.17                        |
| 2010 and 2011                           | 1,934               | 6.59                        | 7,225  | 7.54                        |              |                             | 3,824      | 7.67                        | 775                    | 10.25                       | 13,758          | 7.60                        |
| 2012 to 2016                            | 6,473               | 5.76                        | 779  | 7.73                        |              |                             | 5,881      | 7.42                        | 26                     | 9.64                        | 13,159          | 6.63                        |
| 2017 to 2031                            | 26,178              | 6.15                        | 24,622   | 7.23                        |              |                             | 165,485    | 6.59                        |                        |                             | 216,285         | 6.61                        |
| 2032 and following                      | 379,917             | 5.92                        | 33,593   | 6.79                        |              |                             |            |                             |                        |                             | 413,510         | 5.99                        |
| Total                                   | \$ 421,064          | 5.93%                       | \$ 94,544  | 7.36%                       | \$ 18,866    | 9.42%                       | \$ 178,255 | 6.70%                       | \$ 1,398               | 11.08%                      | \$ 714,127      | 6.42%                       |

(1) Includes demand loans, loans having no stated maturity and overdraft loans.

The following schedule illustrates the Company's loan portfolio at December 31, 2007 as the loans reprice. Loans which have adjustable or renegotiable interest rates are shown as maturing in the period during which the loan reprices. The schedule does not reflect the effects of possible prepayments or enforcement of due-on-sale clauses.

| Due During Years Ending<br>December 31, | One- to Four-Family |                             | Real Estate<br>Multi-family and<br>Commercial and Land |                             | Construction |                             | Consumer   |                             | Commercial<br>Business |                             | Total<br>Amount | Weighted<br>Average<br>Rate |
|---|---------------------|-----------------------------|--|-----------------------------|--------------|-----------------------------|------------|-----------------------------|------------------------|-----------------------------|-----------------|-----------------------------|
|   | Amount              | Weighted<br>Average<br>Rate | Amount   | Weighted<br>Average<br>Rate | Amount       | Weighted<br>Average<br>Rate | Amount     | Weighted<br>Average<br>Rate | Amount                 | Weighted<br>Average<br>Rate |                 |                             |
| (Dollars in Thousands)                  |                     |                             |  |                             |              |                             |            |                             |                        |                             |                 |                             |
| 2008(1)                                 | \$ 179,917          | 6.09%                       | \$ 50,951  | 7.65%                       | \$ 18,866    | 9.42%                       | \$ 27,502  | 7.34%                       | \$ 1,398               | 11.08%                      | \$ 278,634      | 6.75%                       |
| 2009                                    | 54,782              | 5.60                        | 10,819   | 6.96                        |              |                             | 65,196     | 6.36                        |                        |                             | 130,797         | 6.09                        |
| 2010 and 2011                           | 116,663             | 5.64                        | 23,604   | 6.98                        |              |                             | 85,429     | 6.75                        |                        |                             | 225,696         | 6.20                        |
| 2012 to 2016                            | 62,612              | 6.31                        | 6,201  | 7.17                        |              |                             | 128        | 9.32                        |                        |                             | 68,941          | 6.40                        |
| 2017 to 2031                            | 7,090               | 5.77                        | 2,969  | 7.41                        |              |                             |            |                             |                        |                             | 10,059          | 6.26                        |
| Total                                   | \$ 421,064          | 5.93%                       | \$ 94,544  | 7.36%                       | \$ 18,866    | 9.42%                       | \$ 178,255 | 6.70%                       | \$ 1,398               | 11.08%                      | \$ 714,127      | 6.42%                       |

(1) Includes demand loans, loans having no stated maturity and overdraft loans.

The total amount of loans due after December 31, 2008 which have predetermined interest rates is \$55.1 million, while the total amount of loans due after such date which have floating or adjustable interest rates is \$605.0 million.

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***One- to Four-Family Residential Real Estate Lending.*** The Company focuses lending efforts primarily on the origination of loans secured by first mortgages on owner-occupied, one- to four-family residences in San Diego and Riverside counties, California. At December 31, 2007, one- to four-family residential mortgage loans totaled \$421.1 million, or 59.0% of our gross loan portfolio.

The Company generally underwrites one- to four-family loans based on the applicant's income and credit history and the appraised value of the subject property. Presently, the Company lends up to 90% of the lesser of the appraised value or purchase price for one- to four-family residential loans. For loans with a loan-to-value ratio in excess of 80%, the Company generally charges a higher interest rate. The Company currently has a very limited quantity of loans with a loan-to-value ratio in excess of 80%. Properties securing our one- to four-family loans are appraised by independent fee appraisers approved by management. Generally, the Company requires borrowers to obtain title insurance, hazard insurance, and flood insurance, if necessary.

National and regional indicators of real estate values show declining prices in the Company's general market area, however, the Company believes that the current loan loss reserves are adequate to cover current expected losses. Further, the Company generally adjusts underwriting criteria by decreasing the appraisal value by 5.0% when underwriting mortgages in declining market areas.

The Company currently originates one- to four-family mortgage loans on either a fixed- or adjustable-rate basis, as consumer demand dictates. The Company's pricing strategy for mortgage loans includes setting interest rates that are competitive with other local financial institutions.

Adjustable-rate mortgages, or ARM loans are offered with flexible initial and periodic repricing dates, ranging from one month to seven years through the life of the loan. The Company uses a variety of indices to reprice ARM loans. During the year ended December 31, 2007, the Company originated \$31.4 million of one- to four-family ARM loans with terms up to 30 years, and \$2.1 million of one- to four-family fixed-rate mortgage loans with terms up to 15 years.

One- to four-family loans may be assumable, subject to the Company's approval, and may contain prepayment penalties. Most ARM loans are written using generally accepted underwriting guidelines. Due mainly, however, to the generally large loan size, these loans may not be readily saleable to Freddie Mac or Fannie Mae, but are saleable to other private investors. The Company's real estate loans generally contain a due on sale clause allowing us to declare the unpaid principal balance due and payable upon the sale of the security property.

The Company no longer offers ARM loans which may provide for negative amortization of the principal balance. At December 31, 2007, the existing negative amortizing loans in the portfolio totaling \$48.2 million have monthly interest rate adjustments after the specified introductory rate term, and annual maximum payment adjustments of 7.5% during the first five years of the loan. The principal balance on these loans may increase up to 110% of the original loan amount as a result of the payments not being sufficient to cover the interest due during the first five years of the loan term. These loans adjust to fully amortize after five years through contractual maturity, or upon the outstanding loan balance reaching 110% of the original loan amount with up to a 30-year term.

In addition, the Bank currently offers interest only loans and expects originations of these loans to continue. At December 31, 2007, the Company had a total of \$294.3 million of interest only loans. These loans become fully amortized after the initial fixed rate period.

In order to remain competitive in our market areas, the Company generally originates ARM loans at initial rates below the fully indexed rate. The Company's ARM loans generally provide for specified minimum and maximum interest rates, with a lifetime cap, and a periodic adjustment on the interest rate over the rate in effect on the date of origination. As a consequence of using caps, the interest rates on these loans may not be as rate sensitive as is the Company's cost of funds.

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ARM loans generally pose different credit risks than fixed-rate loans, primarily because as interest rates rise, the borrower's minimum monthly payment rises, increasing the potential for default. The Company has not experienced significant delinquencies in these loans. However, the majority of these loans have been originated within the past four years. See *Asset Quality Non-performing Assets and Classified Assets*. At December 31, 2007, the Company's one- to four-family ARM loan portfolio totaled \$410.6 million, or 57.5% of our gross loan portfolio. At that date, the fixed-rate one-to four-family mortgage loan portfolio totaled \$10.4 million, or 1.5% of the Company's gross loan portfolio. The composition of the Company's loan portfolio has not significantly changed during 2007. Further, the Company does not originate sub prime loans and has no plans to originate sub prime loans.

Fixed-rate loans secured by one- to four-family residences have contractual maturities of up to 15 years, and are generally fully amortizing, with payments due monthly.

***Commercial and Multi-Family Real Estate Lending.*** The Company offers a variety of multi-family and commercial real estate loans. These loans are secured primarily by multi-family dwellings, and a limited amount of small retail establishments, hotels, motels, warehouses, and small office buildings primarily located in the Company's market area. At December 31, 2007, multi-family, commercial and land real estate loans totaled \$94.5 million or 13.2% of the Company's gross loan portfolio.

The Company's loans secured by multi-family and commercial real estate are originated with either a fixed or adjustable interest rate. The interest rate on adjustable-rate loans is based on a variety of indices, generally determined through negotiation with the borrower. Loan-to-value ratios on multi-family real estate loans typically do not exceed 75% of the appraised value of the property securing the loan. These loans typically require monthly payments, may contain balloon payments and have maximum maturities of 30 years. Loan-to-value ratios on commercial real estate loans typically do not exceed 70% of the appraised value of the property securing the loan and have maximum maturities of 25 years.

Loans secured by multi-family and commercial real estate are underwritten based on the income producing potential of the property and the financial strength of the borrower. The net operating income, which is the income derived from the operation of the property less all operating expenses, must be sufficient to cover the payments related to the outstanding debt. The Company generally requires an assignment of rents or leases in order to be assured that the cash flow from the project will be used to repay the debt. Appraisals on properties securing multi-family and commercial real estate loans are performed by independent state licensed fee appraisers approved by management. See *Loan Originations, Purchases, Sales and Repayments*.

The Company generally maintains a tax or insurance escrow account for loans secured by multi-family and commercial real estate. In order to monitor the adequacy of cash flows on income-producing properties, the borrower may be requested or required to provide periodic financial information.

Loans secured by multi-family and commercial real estate properties generally involve a greater degree of credit risk than one- to four-family residential mortgage loans. These loans typically involve large balances to single borrowers or groups of related borrowers. The largest multi-family or commercial real estate loan at December 31, 2007 was secured by property located in Riverside County with a principal balance of \$9.4 million. At December 31, 2007, this loan was performing in accordance with the terms of the note.

Because payments on loans secured by multi-family and commercial real estate properties are often dependent on the successful operation or management of the properties, repayment of these loans may be subject to adverse conditions in the real estate market or the economy. If the cash flow from the project is reduced, or if leases are not obtained or renewed, the borrower's ability to repay the loan may be impaired. See *Asset Quality Non-performing Loans*.

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**Construction Lending.** The Company has not historically originated a significant amount of construction loans. From time to time the Company does, however, purchase participations in real estate construction loans. In addition, the Company may in the future originate or purchase loans or participations in construction. At December 31, 2007, the Company had \$18.9 million in construction loans outstanding, representing less than 3% of our gross loan portfolio. At December 31, 2007, one construction loan in the amount of \$9.9 million was in the process of foreclosure and a specific loan loss reserve of \$1.6 million was made based on current loss expectations. The Company had a commitment to fund an additional \$35 thousand of construction loans at December 31, 2007.

**Consumer and Other Real Estate Lending.** Consumer loans generally have shorter terms to maturity or variable interest rates, which reduces our exposure to changes in interest rates, and carry higher rates of interest than do conventional one- to four-family residential mortgage loans. In addition, management believes that offering consumer loan products helps to expand and create stronger ties to the Company's existing customer base by increasing the number of customer relationships and providing cross-marketing opportunities. At December 31, 2007, the Company's consumer and other loan portfolio totaled \$179.7 million, or 25.2% of our gross loan portfolio. The Company offers a variety of secured consumer loans, including the Company's Green Account first and second trust deed home equity loans introduced in 2005, which comprises the majority of the consumer and other real estate real estate portfolio, other home equity lines of credit, new and used auto loans, boat and recreational vehicle loans, and loans secured by savings deposits. The Company also offers a limited amount of unsecured loans. The Company originates consumer and other real estate loans primarily in its market area.

The Company's home equity lines of credit totaled \$175.7 million, and comprised 24.6% of the gross loan portfolio at December 31, 2007. Of these, \$164.0 million represent the Company's Green Account loans which represented 22.9% of the gross loan portfolio at December 31, 2007. Green Account home equity loans have a fifteen year draw period with interest-only payment requirements, a balloon payment requirement at the end of the Draw Period and a maximum 80% loan to value ratio. Home equity lines of credit, other than the Green Account loans, may be originated in amounts, together with the amount of the existing first mortgage, up to 90% of the value of the property securing the loan. Other home equity lines of credit have a seven or ten year draw period and require the payment of 1.0% or 1.5% of the outstanding loan balance per month (depending on the terms) during the draw period, which amount may be re-borrowed at any time during the draw period. Home equity lines of credit with a 10 year draw period have a balloon payment due at the end of the draw period. For loans with shorter term draw periods, once the draw period has lapsed, generally the payment is fixed based on the loan balance at that time. At December 31, 2007, unfunded commitments on these lines of credit totaled \$68.3 million. Other consumer loan terms vary according to the type of collateral, length of contract and creditworthiness of the borrower.

Auto loans totaled \$430 thousand at December 31, 2007, or 0.1% of the Company's gross loan portfolio. Auto loans may be written for up to six years and usually have fixed rates of interest. Loan-to-value ratios are up to 100% of the sales price for new autos and 100% of retail value on used autos, based on valuation from official used car guides.

Consumer and other real estate loans may entail greater risk than do one- to four-family residential mortgage loans, particularly in the case of consumer loans which are secured by rapidly depreciable assets, such as automobiles and recreational vehicles. In these cases, any repossessed collateral for a defaulted loan may not provide an adequate source of repayment of the outstanding loan balance. As a result, consumer loan collections are dependent on the borrower's continuing financial stability and, thus, are more likely to be adversely affected by job loss, divorce, illness, or personal bankruptcy.

**Commercial Business Lending.** At December 31, 2007, commercial business loans totaled \$1.4 million or 0.2% of the gross loan portfolio. The Company's commercial business lending policy includes credit file documentation and analysis of the borrower's background, capacity to repay the loan, the adequacy of the

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borrower's capital and collateral as well as an evaluation of other conditions affecting the borrower. Analysis of the borrower's past, present and future cash flows is also an important aspect of our credit analysis. The Company may obtain personal guarantees on our commercial business loans. Nonetheless, these loans are believed to carry higher credit risk than more traditional single-family home loans.

Unlike residential mortgage loans, commercial business loans are typically made on the basis of the borrower's ability to make repayment from the cash flow of the borrower's business. As a result, the availability of funds for the repayment of commercial business loans may be substantially dependent on the success of the business itself (which, in turn, is often dependent in part upon general economic conditions). The Company's commercial business loans are usually, but not always, secured by business assets. However, the collateral securing the loans may depreciate over time, may be difficult to appraise and may fluctuate in value based on the success of the business.

## **Loan Originations, Purchases, Repayments, and Servicing**

The Company originates real estate secured loans primarily through mortgage brokers and banking relationships. By originating most loans through brokers, the Company is better able to control overhead costs and efficiently utilize management resources. The Company is a portfolio lender of products not readily saleable to Fannie Mae and Freddie Mac, although they are saleable to private investors. The Company did not attempt to sell any of its loans during 2007 and is not planning to do so in the near future.

The Company also originates consumer and real estate loans on a direct basis through our marketing efforts, and our existing and walk-in customers. While the Company originates both adjustable and fixed-rate loans, the ability to originate loans is dependent upon customer demand for loans in our market areas. Demand is affected by competition and the interest rate environment. During the last few years, the Company has significantly increased our origination of ARM loans. The Company has also purchased ARM loans secured by one-to four- family residences and participations in construction and commercial real estate loans. Loans and participations purchased must conform to the Company's underwriting guidelines or guidelines acceptable to the management loan committee. Furthermore, during the past few years, the Company, like many other financial institutions, has experienced significant prepayments on loans due to the low interest rate environment prevailing in the United States. The Company expects loan prepayments to decrease in 2008. In periods of economic uncertainty, the ability of financial institutions to originate or purchase large dollar volumes of real estate loans may be substantially reduced or restricted, with a resultant decrease in interest income. During 2005, the Company introduced a new lending product called the Green Account, America's first fully transactional flexible mortgage account. Originations of this product totaled \$139.6 million and \$77.6 million for the years ended December 31, 2007 and 2006, respectively. Origination volume in this new product is expected to increase in 2008.

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The following table shows loan origination, purchase, sale, and repayment activities for the periods indicated.

|   | Year Ended December 31, |           |            |
|---|-------------------------|-----------|------------|
|   | 2007                    | 2006      | 2005       |
|   | (In thousands)          |           |            |
| <b>Originations by type:</b>            |                         |           |            |
| Adjustable rate:                        |                         |           |            |
| Real estate one- to four-family         | \$ 31,382               | \$ 89,272 | \$ 170,339 |
| multi-family and commercial             | 14,613                  | 8,515     | 5,502      |
| construction or development             | 5,216                   | 10,781    | 6,585      |
| Consumer and other                      | 148,488*                | 88,568    | 26,291     |
| commercial business                     | 860                     | 2,230     | 1,973      |
| Total adjustable-rate                   | 200,559                 | 199,366   | 210,690    |
| Fixed rate:                             |                         |           |            |
| Real estate one- to four-family         | 2,116                   | 12,681    | 15,514     |
| multi-family and commercial             | 14,856                  | 27,098    | 28,125     |
| Non-real estate consumer                | 655                     | 883       | 1,086      |
| commercial business                     | 3,832                   |           |            |
| Total fixed-rate                        | 21,459                  | 40,662    | 44,725     |
| Total loans originated                  | 222,018                 | 240,028   | 255,415    |
| <b>Purchases:</b>                       |                         |           |            |
| Real estate one- to four-family         | 1,058                   |           | 25,483     |
| multi-family and commercial             |                         |           |            |
| construction or development             |                         |           |            |
| Consumer and other                      |                         |           |            |
| commercial business                     |                         |           |            |
| Total loans purchased                   | 1,058                   |           | 25,483     |
| <b>Repayments:</b>                      |                         |           |            |
| Principal repayments                    | (251,658)               | (188,773) | (221,394)  |
| Increase (decrease) in other items, net | (1,367)                 | 292       | 269        |
| Net increase (decrease)                 | \$ (29,949)             | \$ 51,547 | \$ 59,773  |

\* Of this total, \$139.6 million represents originations of the Company's Green account product of which \$137.2 million is secured one-to four-family properties, \$1.2 million is secured by multi-family properties, \$744 thousand is secured by commercial properties and \$429 thousand is secured by land.

**Asset Quality**

Real estate loans are serviced in house in accordance with secondary market guidelines. When a borrower fails to make a payment on a mortgage loan on or before the default date, a late charge notice is mailed 16 days after the due date. All delinquent accounts are reviewed by a collector, who attempts to cure the delinquency by contacting the borrower prior to the loan becoming 30 days past due. If the loan becomes 60 days delinquent, the collector will generally contact by phone or send a personal letter to the borrower in order to identify the reason for the delinquency. Once the loan becomes 90 days delinquent, contact with the borrower is made requesting payment of the delinquent amount in full, or the establishment of an acceptable repayment plan to bring the loan current. When a loan is between 100 and 120 days delinquent, a drive-by inspection is made. If the account becomes 120 days delinquent, and an acceptable repayment plan has not been agreed upon, a collection officer will generally initiate foreclosure or refer the account to the Company's counsel to initiate foreclosure proceedings.



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For consumer loans a similar process is followed, with the initial written contact being made once the loan is 10 days past due with a follow-up notice at 16 days past due. Follow-up contacts are generally on an accelerated basis compared to the mortgage loan procedure.

**Delinquent Loans.** The following table sets forth our loan delinquencies by type, number, and amount at December 31, 2007.

|   | Loans Delinquent For: |                            |                 |                            | Total                            |                            |
|---|-----------------------|----------------------------|-----------------|----------------------------|----------------------------------|----------------------------|
|   | 60-89 Days            |                            | 90 Days or More |                            | Loans Delinquent 60 days or more |                            |
|   | Number of Loans       | Principal Balance of Loans | Number of Loans | Principal Balance of Loans | Number of Loans                  | Principal Balance of Loans |
|   |                       |                            |                 | (Dollars in thousands)     |                                  |                            |
| One- to four-family                     | 7                     | \$ 2,014                   | 4               | \$ 1,941                   | 11                               | \$ 3,955                   |
| Commercial and multi-family real estate |                       |                            | 1               | 57                         | 1                                | 57                         |
| Home equity                             | 4                     | 1,432                      | 2               | 1,402                      | 6                                | 2,834                      |
| Construction                            |                       |                            | 1               | 9,957                      | 1                                | 9,957                      |
| Commercial                              |                       |                            | 1               | 775                        | 1                                | 775                        |
| Consumer                                | 23                    | 109                        |                 |                            | 23                               | 109                        |
|   | 34                    | \$ 3,555                   | 9               | \$ 14,132                  | 43                               | \$ 17,687                  |

Delinquent loans to total gross loans 0.50% 1.98% 2.48%

**Non-performing Assets.** The table below sets forth the amounts and categories of non-performing assets in our loan portfolio. Loans are placed on non-accrual status when the loan becomes more than 90 days delinquent. At all dates presented, the Company had no troubled debt restructurings which involve forgiving a portion of interest or principal on any loans or making loans at a rate materially less than that of market rates. Foreclosed assets owned include assets acquired in settlement of loans.

|   | 2007      | December 31,           |      |      |      |
|---|-----------|------------------------|------|------|------|
|   |           | 2006                   | 2005 | 2004 | 2003 |
|   |           | (Dollars in Thousands) |      |      |      |
| <i>Nonaccrual loans:</i>                            |           |                        |      |      |      |
| One- to four-family                                 | \$ 1,941  | \$ 1,950               | \$   | \$   | \$   |
| Commercial and Multi-family real estate             | 57        |                        |      |      |      |
| Home equity   | 1,402     |                        |      |      |      |
| Construction  | 9,957     |                        |      |      |      |
| Commercial  | 775       |                        |      |      |      |
| Consumer  |           | 2                      | 3    | 4    | 1    |
| Total   | 14,132    | 1,952                  | 3    | 4    | 1    |
| <i>Accruing loans delinquent more than 90 days:</i> |           |                        |      |      |      |
| One- to four-family                                 |           |                        |      |      |      |
| Commercial and Multi-family real estate             |           |                        |      |      |      |
| Home equity   |           |                        |      |      |      |
| Construction  |           |                        |      |      |      |
| Commercial  |           |                        |      |      |      |
| Consumer  |           |                        |      |      |      |
| Total   |           |                        |      |      |      |
| Non-performing loans                                | 14,132    | 1,952                  | 3    | 4    | 1    |
| Foreclosed Assets                                   |           |                        |      |      |      |
| Total non-performing assets                         | \$ 14,132 | \$ 1,952               | \$ 3 | \$ 4 | \$ 1 |



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|                                       |       |       |   |   |   |
|---------------------------------------|-------|-------|---|---|---|
| Non-performing loans to total loans   | 1.98% | 0.26% | % | % | % |
| Non-performing assets to total assets | 1.82% | 0.24% | % | % | % |

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Due to recent deterioration of the housing and credit markets, the Company's nonaccrual loans increased \$12.2 million over the prior year. At December 31, 2007, nonaccrual loans totaled \$14.1 million, which consisted of nine loans: eight loans in the process of foreclosure and one delinquent commercial loan as of December 31, 2007. This balance of nonaccrual loans is primarily comprised of one construction loan in foreclosure with a loan balance of \$9.9 million. The Company has allocated specific reserves totaling \$2.3 million for four of the nine nonaccrual loans based on current expected losses. The Company does not anticipate any losses on the remaining five loans at this time.

**Classified Assets.** Federal regulations provide for the classification of loans and other assets, such as debt and equity securities considered by the Office of Thrift Supervision to be of lesser quality, as substandard, doubtful or loss. An asset is considered substandard if it is inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. Substandard assets include those characterized by the distinct possibility that the insured institution will sustain some loss if the deficiencies are not corrected. Assets classified as doubtful have all of the weaknesses inherent in those classified substandard, with the added characteristic that the weaknesses present make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable. Assets classified as loss are those considered uncollectible and of such little value that their continuance as assets without the establishment of a specific loss reserve is not warranted.

When an insured institution classifies problem assets as either substandard or doubtful, it may establish general allowances for loan losses in an amount deemed prudent by management and approved by the board of directors. General allowances represent loss allowances which have been established to recognize the inherent risk associated with lending activities, but which, unlike specific allowances, have not been allocated to particular problem assets. When an insured institution classifies problem assets as loss, it is required either to establish a specific allowance for losses equal to 100% of that portion of the asset so classified or to charge off such amount. An institution's determination as to the classification of its assets and the amount of its valuation allowances is subject to review by the Office of Thrift Supervision and the FDIC, which may order the establishment of additional general or specific loss allowances.

In connection with the filing of our periodic reports with the Office of Thrift Supervision and in accordance with our classification of assets policy, we regularly review the problem assets in our portfolio to determine whether any assets require classification in accordance with applicable regulations. On the basis of management's review of assets, at December 31, 2007, the Company had classified assets totaling \$18.7 million of which \$8.7 million was classified as substandard, \$10.0 million as doubtful and \$0 as loss. The total amount classified represented 22.2% of our equity capital and 2.4% of our assets at December 31, 2007.

**Provision for Loan Losses.** The Company recorded a loan provision for the year ended December 31, 2007 of \$1.6 million, compared to a loan provision recovery of \$24 thousand for the year ended December 31, 2006. The provision for loan losses is charged or credited to income to adjust our allowance for loan losses to reflect probable losses presently inherent in the loan portfolio based on the factors discussed below under Allowance for Loan Losses. The provision for loan losses for the year ended December 31, 2007 was based on management's review of such factors which indicated that the allowance for loan losses reflected probable losses presently inherent in the loan portfolio as of the year ended December 31, 2007.

**Allowance for Loan Losses.** The Company maintains an allowance for loan losses to absorb probable losses presently inherent in the loan portfolio. The allowance is based on ongoing, quarterly assessments of the estimated probable losses presently inherent in the loan portfolio. In evaluating the level of the allowance for loan losses, management considers the types of loans and the amount of loans in the loan portfolio, peer group information, historical loss experience, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral, and prevailing economic conditions. Large groups of smaller balance homogeneous loans, such as residential real estate, home equity and consumer loans are evaluated in the aggregate using historical loss factors and peer group data adjusted for current economic conditions.  
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peer group data is obtained by general loan type and adjusted to reflect known differences between peers and the Company, including loan seasoning, underwriting experience, local economic conditions and customer characteristics. More complex loans, such as multi-family and commercial real estate loans, are evaluated individually for impairment, primarily through the evaluation of collateral values and cash flows.

At December 31, 2007, our allowance for loan losses was \$6.2 million or 0.87% of the total loan portfolio. Assessing the allowance for loan losses is inherently subjective as it requires making material estimates, including the amount and timing of future cash flows expected to be received on impaired loans that may be susceptible to significant change. In the opinion of management, the allowance, when taken as a whole, reflects estimated probable losses presently inherent in our loan portfolios.

The following table sets forth an analysis of our allowance for loan losses.

|  | 2007     | 2006     | Year Ended December 31, |          | 2003     |
|--|----------|----------|-------------------------|----------|----------|
|  |          |          | 2005                    | 2004     |          |
|  |          |          | (Dollars in Thousands)  |          |          |
| Balance at beginning of period                                     | \$ 4,670 | \$ 4,691 | \$ 4,430                | \$ 4,232 | \$ 2,953 |
| <i>Charge-offs</i>   |          |          |                         |          |          |
| One- to four-family  |          |          |                         |          |          |
| Multi-family   |          |          |                         |          |          |
| Construction   |          |          |                         |          |          |
| Commercial   |          |          |                         |          |          |
| Consumer   | (24)     | (15)     | (25)                    | (98)     | (56)     |
|  | (24)     | (15)     | (25)                    | (98)     | (56)     |
| <i>Recoveries</i>  |          |          |                         |          |          |
| One- to four-family  |          |          |                         |          |          |
| Multi-family   |          |          |                         |          |          |
| Construction   |          |          |                         |          |          |
| Commercial   |          |          |                         |          |          |
| Consumer   | 6        | 18       | 36                      | 58       | 63       |
|  | 6        | 18       | 36                      | 58       | 63       |
| Net (charge-offs) recoveries                                       | (18)     | 3        | 11                      | (40)     | 7        |
| Provision/(recovery) for loan losses                               | 1,588    | (24)     | 250                     | 238      | 1,272    |
| Balance at end of period   | \$ 6,240 | \$ 4,670 | \$ 4,691                | \$ 4,430 | \$ 4,232 |
| Net charge-offs to average loans during this period                | %        | %        | %                       | %        | %        |
| Net charge-offs to average non-performing loans during this period | %        | %        | %                       | %        | %        |
| Allowance for loan losses to non-performing loans                  | 44.16%   | 239.24%  | 156,367%                | 110,750% | 423,200% |
| Allowance as a % of total loans (end of period)                    | 0.87%    | 0.63%    | 0.68%                   | 0.70%    | 0.72%    |

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The distribution of our allowance for loan losses at the dates indicated is summarized as follows:

| 2007                   |   |  | 2006     |   |  | 2005     |   |  | 2004     |   |  | 2003     |   |
|------------------------|---|--|----------|---|--|----------|---|--|----------|---|--|----------|---|
| Amount                 | Percent of Allowance to Total Allowance | Percent of Gross Loans in Each Category to Total Gross Loans | Amount   | Percent of Allowance to Total Allowance | Percent of Gross Loans in Each Category to Total Gross Loans | Amount   | Percent of Allowance to Total Allowance | Percent of Gross Loans in Each Category to Total Gross Loans | Amount   | Percent of Allowance to Total Allowance | Percent of Gross Loans in Each Category to Total Gross Loans | Amount   | Percent of Allowance to Total Allowance |
| (Dollars in Thousands) |   |  |          |   |  |          |   |  |          |   |  |          |   |
| \$ 2,078               | 33.30%                                  | 59.04%   | \$ 3,503 | 75.01%                                  | 69.56%   | \$ 3,702 | 78.92%                                  | 80.87%   | \$ 3,623 | 81.78%                                  | 81.90%   | \$ 3,474 | 82.09%                                  |
| 499                    | 8.00                                    | 13.25  | 615      | 13.17                                   | 14.34  | 667      | 14.22                                   | 13.98  | 578      | 13.05                                   | 15.29  | 450      | 10.63                                   |
| 1,702                  | 27.27                                   | 2.65   | 69       | 1.48                                    | 2.21   | 39       | 0.83                                    | 0.93   | 1        | 0.02                                    | 0.02   | 12       | 0.28                                    |
| 1,362                  | 21.83                                   | 24.86  | 466      | 9.98                                    | 13.81  | 269      | 5.73                                    | 4.13   | 217      | 4.90                                    | 2.68   | 279      | 6.59                                    |
| 599                    | 9.60                                    | 0.20   | 17       | 0.36                                    | 0.08   | 14       | 0.30                                    | 0.09   | 11       | .25                                     | 0.11   | 17       | 0.41                                    |
| \$ 6,240               | 100.00%                                 | 100.00%  | \$ 4,670 | 100.00%                                 | 100.00%  | \$ 4,691 | 100.00%                                 | 100.00%  | \$ 4,430 | 100.00%                                 | 100.00%  | \$ 4,232 | 100.00%                                 |

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**Investment Activities**

Federally chartered savings institutions have the authority to invest in various types of liquid assets, including United States Treasury obligations, securities of various federal agencies, including callable agency securities, certain certificates of deposit of insured banks and savings institutions, certain bankers' acceptances, repurchase agreements, and federal funds. Subject to various restrictions, federally chartered savings institutions may also invest their assets in investment grade commercial paper and corporate debt securities and mutual funds whose assets conform to the investments that a federally chartered savings institution is otherwise authorized to make directly. See "How We Are Regulated" Pacific Trust Bank and "Qualified Thrift Lender Test" for a discussion of additional restrictions on our investment activities.

The general objectives of our investment portfolio are to provide liquidity when loan demand is high, to assist in maintaining earnings when loan demand is low and to maximize earnings while satisfactorily managing risk, including credit risk, reinvestment risk, liquidity risk and interest rate risk. See Item 7A "Quantitative and Qualitative Disclosures About Market Risk."

The Company may invest in CMOs as an alternative to mortgage loans and conventional mortgage-backed securities as part of our asset/liability management strategy. Management believes that CMOs can represent attractive investment alternatives relative to other investments due to the wide variety of maturity and repayment options available through such investments. In particular, the Company has from time to time concluded that short and intermediate duration CMOs (with an expected average life of five years or less) represent a better combination of rate and duration than adjustable rate mortgage-backed securities. All of the Company's negotiable securities, including CMOs, are held as available for sale.

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The following table sets forth the composition of our securities portfolio and other investments at the dates indicated. Our securities portfolio at December 31, 2007, did not contain securities of any issuer with an aggregate book value in excess of 10% of our equity capital, excluding those issued by the United States Government or its agencies. In February, 2008 the two agency notes totaling \$4.4 million were called.

|   | 2007            |                | December 31, 2006 |                | 2005             |                |
|---|-----------------|----------------|-------------------|----------------|------------------|----------------|
|   | Carrying Value  | % of Total     | Carrying Value    | % of Total     | Carrying Value   | % of Total     |
| (Dollars in Thousands)                      |                 |                |                   |                |                  |                |
| <b>Securities Available for Sale:</b>       |                 |                |                   |                |                  |                |
| Agency securities FNMA/FHLB notes           | \$ 4,361        | 99.86%         | \$ 13,982         | 99.95%         | \$ 14,003        | 99.94%         |
| <b>Collateralized mortgage obligations:</b> |                 |                |                   |                |                  |                |
| Federal National Mortgage Association       | 5               | 0.12%          | 6                 | 0.04%          | 8                | 0.05%          |
| Government National Mortgage Association    | 1               | 0.02%          | 1                 | 0.01%          | 1                | 0.01%          |
| Marketable equity securities                |                 |                |                   |                |                  |                |
| <b>Total</b>                                | <b>\$ 4,367</b> | <b>100.00%</b> | <b>\$ 13,989</b>  | <b>100.00%</b> | <b>\$ 14,012</b> | <b>100.00%</b> |
| Average remaining life of securities        | 5.2 years       |                | 3.9 years         |                | 4.9 years        |                |
| <b>Other interest earning assets:</b>       |                 |                |                   |                |                  |                |
| Interest-earning deposits with banks        | 7,602           | 32.94%         | 7,808             | 43.75%         | 7,870            | 44.56%         |
| Federal funds sold                          | 8,635           | 37.41%         | 245               | 1.37%          | 1,270            | 7.19%          |
| FHLB stock                                  | 6,842           | 29.65%         | 9,794             | 54.88%         | 8,523            | 48.25%         |
|   | \$ 23,079       | 100.00%        | \$ 17,847         | 100.00%        | \$ 17,663        | 100.00%        |

The composition and maturities of the securities portfolio, excluding Federal Home Loan Bank stock as of December 31, 2007 are indicated in the following table.

|                                     | December 31, 2007               |                                  |                                 |                              | Total Securities |                 |
|-------------------------------------|---------------------------------|----------------------------------|---------------------------------|------------------------------|------------------|-----------------|
|                                     | One Year or Less Amortized Cost | One to Five Years Amortized Cost | Five to 10 Years Amortized Cost | Over 10 Years Amortized Cost | Amortized Cost   | Fair Value      |
| (Dollars in Thousands)              |                                 |                                  |                                 |                              |                  |                 |
| Agency securities FNMA/FHLB Notes   | \$                              | \$                               | \$ 4,347                        | \$                           | \$ 4,347         | \$ 4,361        |
| Collateralized mortgage obligations | \$                              | \$ 5                             | \$                              | \$                           | \$ 5             | \$ 6            |
| <b>Total investment securities</b>  | <b>\$</b>                       | <b>\$ 5</b>                      | <b>\$ 4,347</b>                 | <b>\$</b>                    | <b>\$ 4,352</b>  | <b>\$ 4,367</b> |
| Weighted average yield              | 0%                              | 6.37%                            | 4.98%                           | 0%                           |                  |                 |

In February, 2008 the two agency notes totaling \$4.4 million were called.

**Sources of Funds**

**General.** The Company's sources of funds are deposits, borrowings, payment of principal and interest on loans, interest earned on or maturation of other investment securities and funds provided from operations.

**Deposits.** The Company offers a variety of deposit accounts to both consumers and businesses having a wide range of interest rates and terms. The Company's deposits consist of savings accounts, money market deposit accounts, NOW and demand accounts and certificates of deposit. The Company solicits deposits primarily in our market area and from institutional investors. The Company has also accepted brokered deposits



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and held \$3.8 million of brokered certificates of deposit at December 31, 2007. This represents a reduction of \$17.9 million from the prior year as the Company continues to reduce its reliance on brokered deposits. The Company primarily relies on competitive pricing policies, marketing and customer service to attract and retain deposits.

The flow of deposits is influenced significantly by general economic conditions, changes in money market and prevailing interest rates and competition. The variety of deposit accounts the Company offers has allowed the Company to be competitive in obtaining funds and to respond with flexibility to changes in consumer demand. The Company has become more susceptible to short-term fluctuations in deposit flows, as customers have become more interest rate conscious. The Company tries to manage the pricing of our deposits in keeping with our asset/liability management, liquidity and profitability objectives, subject to competitive factors. Based on our experience, the Company believes that our deposits are relatively stable sources of funds. Despite this stability, the Company's ability to attract and maintain these deposits and the rates paid on them has been and will continue to be significantly affected by market conditions.

The following table sets forth our deposit flows during the periods indicated.

|                             | Year Ended December 31, |            |            |
|-----------------------------|-------------------------|------------|------------|
|                             | 2007                    | 2006       | 2005       |
| (Dollars in Thousands)      |                         |            |            |
| Opening balance             | \$ 570,543              | \$ 508,156 | \$ 453,581 |
| Deposits net of withdrawals | (20,255)                | 42,804     | 42,443     |
| Interest credited           | 23,863                  | 19,583     | 12,132     |
| Ending balance              | \$ 574,151              | \$ 570,543 | \$ 508,156 |
| Net increase                | \$ 3,608                | \$ 62,387  | \$ 54,575  |
| Percent increase            | .63%                    | 12.28%     | 12.03%     |

The following table sets forth the dollar amount of savings deposits in the various types of deposit programs we offered at the dates indicated.

|                               | 2007       |                     | December 31,<br>2006 |                     | 2005       |                     |
|-------------------------------|------------|---------------------|----------------------|---------------------|------------|---------------------|
|                               | Amount     | Percent of<br>Total | Amount               | Percent of<br>Total | Amount     | Percent of<br>Total |
| (Dollars in Thousands)        |            |                     |                      |                     |            |                     |
| Noninterest-bearing demand    | \$ 17,873  | 3.11%               | \$ 14,362            | 2.52%               | \$ 16,706  | 3.29%               |
| Savings                       | 80,625     | 14.04               | 43,440               | 7.61                | 57,076     | 11.23               |
| NOW                           | 41,115     | 7.16                | 52,917               | 9.27                | 64,012     | 12.60               |
| Money market                  | 129,466    | 22.55               | 169,708              | 29.75               | 123,557    | 24.31               |
|                               | 269,079    | 46.86               | 280,427              | 49.15               | 261,351    | 51.43               |
| Certificates of deposit       |            |                     |                      |                     |            |                     |
| 0.00% - 2.99%                 | 89         | 0.02                | 4,473                | 0.78                | 26,878     | 5.29                |
| 3.00% - 3.99%                 | 15,119     | 2.63                | 31,052               | 5.44                | 152,039    | 29.92               |
| 4.00% - 4.99%                 | 135,639    | 23.63               | 104,107              | 18.25               | 63,522     | 12.50               |
| 5.00% - 5.99%                 | 154,225    | 26.86               | 150,484              | 26.38               | 4,366      | 0.86                |
| 6.00% - 6.99%                 |            |                     |                      |                     |            |                     |
| 7.00% - 7.99%                 |            |                     |                      |                     |            |                     |
| Total Certificates of Deposit | 305,072    | 53.14               | 290,116              | 50.85               | 246,805    | 48.57               |
|                               | \$ 574,151 | 100.00%             | \$ 570,543           | 100.00%             | \$ 508,156 | 100.00%             |





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The following table (in thousands) indicates the amount of the Company's certificates of deposit and other deposits by time remaining until maturity as of December 31, 2007.

|                    | 2008       | 2009      | 2010     | 2011     | 2012     | Total      |
|--------------------|------------|-----------|----------|----------|----------|------------|
| 0.00% - 2.99%      | \$ 88      | \$ 1      |          |          |          | \$ 89      |
| 3.00% - 3.99%      | 9,910      | 4,827     | 382      |          |          | 15,119     |
| 4.00% - 4.99%      | 113,025    | 10,524    | 8,652    | 1,244    | 2,194    | 135,639    |
| 5.00% - 5.99%      | 151,372    | 1,113     | 416      | 1,125    | 199      | 154,225    |
| 6.00% - 6.99%      |            |           |          |          |          |            |
| 7.00% - 7.99%      |            |           |          |          |          |            |
|                    | \$ 274,395 | \$ 16,464 | \$ 9,451 | \$ 2,369 | \$ 2,393 | \$ 305,072 |
| \$100,000 and over | \$ 122,970 | \$ 7,362  | \$ 2,733 | \$ 1,161 | \$ 1,493 | \$ 135,719 |
| Below \$100,000    | 151,425    | 9,102     | 6,718    | 1,208    | 900      | 169,353    |
| Total              | \$ 274,395 | \$ 16,464 | \$ 9,451 | \$ 2,369 | \$ 2,393 | \$ 305,072 |

**Borrowings.** Although deposits are our primary source of funds, the Company may utilize borrowings when they are a less costly source of funds and can be invested at a positive interest rate spread, when the Company desires additional capacity to fund loan demand or when they meet our asset/liability management goals. The Company's borrowings historically have consisted of advances from the Federal Home Loan Bank of San Francisco (FHLB).

The Company may obtain advances from the FHLB upon the security of certain of the Company's mortgage loans and mortgage-backed and other securities. These advances may be made pursuant to several different credit programs, each of which has its own interest rate, range of maturities and call features. At December 31, 2007, the Company had \$111.7 million in Federal Home Loan Bank advances outstanding and the ability to borrow an additional \$157.9 million. See also Note 7 (Item 8) of the Notes to the Company's consolidated financial statements for additional information regarding FHLB advances.

The following table sets forth certain information as to our borrowings at the dates and for the years indicated.

|  | At or for the Year Ended December 31, |            |            |
|--|---------------------------------------|------------|------------|
|  | 2007                                  | 2006       | 2005       |
|  | (Dollars in Thousands)                |            |            |
| Average balance outstanding                      | \$ 114,562                            | \$ 176,769 | \$ 154,262 |
| Maximum month-end balance                        | \$ 147,200                            | \$ 204,200 | \$ 172,200 |
| Balance at end of period                         | \$ 111,700                            | \$ 151,200 | \$ 164,200 |
| Weighted average interest rate during the period | 4.06%                                 | 4.25%      | 3.04%      |
| Weighted average interest rate at end of period  | 4.55%                                 | 4.64%      | 3.44%      |

**Subsidiary and Other Activities**

As a federally chartered savings bank, Pacific Trust Bank is permitted by the Office of Thrift Supervision to invest 2% of our assets or \$15.5 million at December 31, 2007, in the stock of, or unsecured loans to, service corporation subsidiaries. The Company may invest an additional 1% of our assets in secure corporations where such additional funds are used for inner city or community development purposes. Pacific Trust Bank currently does not have any subsidiary service corporations.

**Competition**

The Company faces strong competition in originating real estate and other loans and in attracting deposits. Competition in originating real estate loans comes primarily from other savings institutions, commercial banks, credit unions and mortgage bankers. Other savings institutions, commercial banks, credit unions and finance companies provide vigorous competition in consumer lending.



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The Company attracts deposits through the branch office system and through the internet. Competition for those deposits is principally from other savings institutions, commercial banks and credit unions located in the same community, as well as mutual funds and other alternative investments. The Company competes for these deposits by offering superior service and a variety of deposit accounts at competitive rates. Based on the most recent branch deposit data as of June 30, 2007 provided by the FDIC, Pacific Trust Bank's share of deposits was 2.28% and 0.57% in San Diego and Riverside Counties, respectively.

## **Employees**

At December 31, 2007, we had a total of 90 full-time employees and 17 part-time employees. Our employees are not represented by any collective bargaining group. Management considers its employee relations to be satisfactory.

## **HOW WE ARE REGULATED**

Set forth below is a brief description of certain laws and regulations which are applicable to First PacTrust Bancorp, Inc. and Pacific Trust Bank. The description of these laws and regulations, as well as descriptions of laws and regulations contained elsewhere herein, does not purport to be complete and is qualified in its entirety by reference to the applicable laws and regulations.

Legislation is introduced from time to time in the United States Congress that may affect the operations of the Company and the Bank. In addition, the regulations governing the Company and the Bank may be amended from time to time by the Office of Thrift Supervision. Any such legislation or regulatory changes in the future could adversely affect the Company or the Bank. No assurance can be given as to whether or in what form any such changes may occur.

## **General**

Pacific Trust Bank, as a federally chartered savings institution, is subject to federal regulation and oversight by the Office of Thrift Supervision extending to all aspects of its operations. The Bank is also subject to regulation and examination by the FDIC, which insures the deposits of the Bank to the maximum extent permitted by law, and requirements established by the Federal Reserve Board. Federally chartered savings institutions are required to file periodic reports with the Office of Thrift Supervision and are subject to periodic examinations by the Office of Thrift Supervision and the FDIC. The investment and lending authority of savings institutions are prescribed by federal laws and regulations, and such institutions are prohibited from engaging in any activities not permitted by such laws and regulations. Such regulation and supervision primarily is intended for the protection of depositors and not for the purpose of protecting shareholders.

The Office of Thrift Supervision regularly examines the Bank and prepares reports for the consideration of the Bank's board of directors on any deficiencies that it may find in the Bank's operations. The FDIC also has the authority to examine the Bank in its role as the administrator of the Savings Association Insurance Fund. Our relationship with its depositors and borrowers also is regulated to a great extent by both Federal and state laws, especially in such matters as the ownership of savings accounts and the form and content of our mortgage requirements. Any change in such regulations, whether by the FDIC, the Office of Thrift Supervision or Congress, could have a material adverse impact on the Company and the Bank and their operations.

## **First PacTrust Bancorp, Inc.**

Pursuant to regulations of the Office of Thrift Supervision and the terms of the Company's Maryland charter, the purpose and powers of the Company are to pursue any or all of the lawful objectives of a thrift holding company and to exercise any of the powers accorded to a thrift holding company.

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First PacTrust Bancorp, Inc. is a unitary savings and loan holding company subject to regulatory oversight by the Office of Thrift Supervision. First PacTrust is required to register and file reports with the Office of Thrift Supervision and is subject to regulation and examination by the Office of Thrift Supervision. In addition, the Office of Thrift Supervision has enforcement authority over us and our non-savings institution subsidiaries.

First PacTrust generally is not subject to activity restrictions. If First PacTrust acquired control of another savings institution as a separate subsidiary, it would become a multiple savings and loan holding company, and its activities and any of its subsidiaries (other than Pacific Trust Bank or any other savings institution) would generally become subject to additional restrictions.

### **Pacific Trust Bank**

The Office of Thrift Supervision has extensive authority over the operations of savings institutions. As part of this authority, we are required to file periodic reports with the Office of Thrift Supervision and we are subject to periodic examinations by the Office of Thrift Supervision and the FDIC. When these examinations are conducted by the Office of Thrift Supervision and the FDIC, the examiners may require the Bank to provide for higher general or specific loan loss reserves. All savings institutions are subject to a semi-annual assessment, based upon the savings institution's total assets, to fund the operations of the Office of Thrift Supervision.

The Office of Thrift Supervision also has extensive enforcement authority over all savings institutions and their holding companies, including the Bank and the Company. This enforcement authority includes, among other things, the ability to assess civil money penalties, to issue cease-and-desist or removal orders and to initiate injunctive actions. In general, these enforcement actions may be initiated for violations of laws and regulations and unsafe or unsound practices. Other actions or inactions may provide the basis for enforcement action, including misleading or untimely reports filed with the Office of Thrift Supervision. Except under certain circumstances, public disclosure of final enforcement actions by the Office of Thrift Supervision is required.

In addition, the investment, lending and branching authority of the Bank is prescribed by federal laws and it is prohibited from engaging in any activities not permitted by such laws. For instance, no savings institution may invest in non-investment grade corporate debt securities. In addition, the permissible level of investment by federal institutions in loans secured by non-residential real property may not exceed 400% of total capital, except with approval of the Office of Thrift Supervision. Federal savings institutions are also generally authorized to branch nationwide. The Bank is in compliance with the noted restrictions.

The Bank's general permissible lending limit for loans-to-one-borrower is equal to the greater of \$500 thousand or 15% of unimpaired capital and surplus including allowance for loan losses (except for loans fully secured by certain readily marketable collateral, in which case this limit is increased to 25% of unimpaired capital and surplus). At December 31, 2007, the Bank's lending limit under this restriction was \$12.3 million. The Bank is in compliance with the loans-to-one-borrower limitation.

The Office of Thrift Supervision, as well as the other federal banking agencies, has adopted guidelines establishing safety and soundness standards on such matters as loan underwriting and documentation, asset quality, earnings standards, internal controls and audit systems, interest rate risk exposure and compensation and other employee benefits. Any institution which fails to comply with these standards must submit a compliance plan.

### **Insurance of Accounts and Regulation by the FDIC**

The Bank is a member of the Savings Association Insurance Fund, which is administered by the FDIC. Deposits are insured up to the applicable limits by the FDIC and such insurance is backed by the full faith and credit of the United States Government. As insurer, the FDIC imposes deposit insurance premiums and is authorized to conduct examinations of and to require reporting by FDIC-insured institutions. It also may prohibit any FDIC-insured institution from engaging in any activity the FDIC determines by regulation or order to pose a serious risk to the Savings Association Insurance Fund or the Bank Insurance Fund. The FDIC also has the

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authority to initiate enforcement actions against savings institutions, after giving the Office of Thrift Supervision an opportunity to take such action, and may terminate the deposit insurance if it determines that the institution has engaged in unsafe or unsound practices or is in an unsafe or unsound condition.

### **Regulatory Capital Requirements**

Federally insured savings institutions, such as the Bank, are required to maintain a minimum level of regulatory capital. The Office of Thrift Supervision has established capital standards, including a tangible capital requirement, a leverage ratio or core capital requirement and a risk-based capital requirement applicable to such savings institutions. These capital requirements must be generally as stringent as the comparable capital requirements for national banks. The Office of Thrift Supervision is also authorized to impose capital requirements in excess of these standards on a case-by-case basis.

The capital regulations require core capital equal to at least 4.0% of adjusted total assets. Core capital consists of tangible capital plus certain intangible assets including a limited amount of credit card relationships. At December 31, 2007, the Bank had core capital equal to \$77.9 million, or 10.05% of adjusted total assets, which was \$46.9 million above the minimum requirement of 4.0% in effect on that date.

The Office of Thrift Supervision also requires savings institutions to have total capital of at least 8.0% of risk-weighted assets. Total capital consists of core capital, as defined above, and supplementary capital. Supplementary capital consists of certain permanent and maturing capital instruments that do not qualify as core capital and general valuation loan and lease loss allowances up to a maximum of 1.25% of risk-weighted assets. Supplementary capital may be used to satisfy the risk-based requirement only to the extent of core capital. The Office of Thrift Supervision is also authorized to require a savings institution to maintain an additional amount of total capital to account for concentration of credit risk and the risk of non-traditional activities. At December 31, 2007, the Bank had \$4.0 million of general loan loss reserves, which was less than 1.25% of risk-weighted assets.

In determining the amount of risk-weighted assets, all assets, including certain off-balance sheet items, will be multiplied by a risk weight, ranging from 0% to 100%, based on the risk inherent in the type of asset. For example, the Office of Thrift Supervision has assigned a risk weight of 50% for prudently underwritten permanent one- to four-family first lien mortgage loans not more than 90 days delinquent and having a loan-to-value ratio of not more than 80% at origination unless insured to such ratio by an insurer approved by Fannie Mae or Freddie Mac.

On December 31, 2007, the Bank had total risk-based capital of \$81.8 million and risk-weighted assets of \$592.7 million; or total risk-based capital of 13.8% of risk-weighted assets. This amount was \$34.4 million above the 8.0% requirement in effect on that date.

The Office of Thrift Supervision and the FDIC are authorized and, under certain circumstances, required to take certain actions against savings institutions that fail to meet their capital requirements. The Office of Thrift Supervision is generally required to take action to restrict the activities of an undercapitalized institution, which is an institution with less than either a 4.0% core capital ratio, a 4.0% Tier 1 risk-based capital ratio or an 8.0% risk-based capital ratio. Any such institution must submit a capital restoration plan and until such plan is approved by the Office of Thrift Supervision may not increase its assets, acquire another institution, establish a branch or engage in any new activities, and generally may not make capital distributions.

Any savings institution that fails to comply with its capital plan or has Tier 1 risk-based or core capital ratios of less than 3.0% or a risk-based capital ratio of less than 6.0% and is considered significantly undercapitalized must be made subject to one or more additional specified actions and operating restrictions which may cover all aspects of its operations and may include a forced merger or acquisition of the institution. An institution that becomes critically undercapitalized because it has a tangible capital ratio of 2.0% or less is subject to further mandatory restrictions on its activities in addition to those applicable to significantly undercapitalized institutions. In addition, the Office of Thrift Supervision must appoint a receiver, or conservator

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with the concurrence of the FDIC, for a savings institution, with certain limited exceptions, within 90 days after it becomes critically undercapitalized. Any undercapitalized institution is also subject to the general enforcement authority of the OTS and the FDIC including the appointment of a conservator or receiver.

The Office of Thrift Supervision is also generally authorized to reclassify an institution into a lower capital category and impose the restrictions applicable to such category if the institution is engaged in unsafe or unsound practices or is in an unsafe or unsound condition.

The imposition by the Office of Thrift Supervision or the FDIC of any of these measures on the Bank may have a substantial adverse effect on its operations and profitability.

### **Limitations on Dividends and Other Capital Distributions**

Office of Thrift Supervision regulations impose various restrictions on savings institutions with respect to their ability to make distributions of capital, which include dividends, stock redemptions or repurchases, cash-out mergers and other transactions charged to the capital account.

Generally, savings institutions, that before and after the proposed distribution remain well-capitalized, such as Pacific Trust Bank, may make capital distributions during any calendar year equal to up to 100% of net income for the year-to-date plus retained net income for the two preceding years. However, an institution deemed to be in need of more than normal supervision by the Office of Thrift Supervision may have its dividend authority restricted by the Office of Thrift Supervision. The Bank may pay dividends in accordance with this general authority.

Savings institutions proposing to make any capital distribution need not submit written notice to the Office of Thrift Supervision prior to such distribution unless they are a subsidiary of a holding company or would not remain well-capitalized following the distribution. Pacific Trust Bank is a subsidiary of a holding company. Savings institutions that do not, or would not meet their current minimum capital requirements following a proposed capital distribution or propose to exceed these net income limitations must obtain Office of Thrift Supervision approval prior to making such distribution. The Office of Thrift Supervision may object to the distribution during that 30-day period based on safety and soundness concerns. See Regulatory Capital Requirements.

### **Liquidity**

All savings institutions, including Pacific Trust Bank, are required to maintain sufficient liquidity to ensure a safe and sound operation.

### **Qualified Thrift Lender Test**

All savings institutions, including Pacific Trust Bank, are required to meet a qualified thrift lender test to avoid certain restrictions on their operations. This test requires a savings institution to have at least 65% of its portfolio assets, as defined by regulation, in qualified thrift investments on a monthly average for nine out of every 12 months on a rolling basis. As an alternative, the savings institution may maintain 60% of its assets in those assets specified in Section 7701(a)(19) of the Internal Revenue Code. Under either test, such assets primarily consist of residential housing related loans and investments. At December 31, 2007, the Bank met the test and has always met the test since the requirement was applicable.

Any savings institution that fails to meet the qualified thrift lender test must convert to a national bank charter, unless it requalifies as a qualified thrift lender and thereafter remains a qualified thrift lender. If an institution does not requalify and converts to a national bank charter, it must remain Savings Association Insurance Fund-insured until the FDIC permits it to transfer to the Bank Insurance Fund. If such an institution has not yet requalified or converted to a national bank, its new investments and activities are limited to those permissible for both a savings institution and a national bank, and it is limited to national bank branching rights

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in its home state. In addition, the institution is immediately ineligible to receive any new Federal Home Loan Bank borrowings and is subject to national bank limits for payment of dividends. If such an institution has not requalified or converted to a national bank within three years after the failure, it must divest of all investments and cease all activities not permissible for a national bank. In addition, it must repay promptly any outstanding Federal Home Loan Bank borrowings, which may result in prepayment penalties. If any institution that fails the qualified thrift lender test is controlled by a holding company, then within one year after the failure, the holding company must register as a bank holding company and become subject to all restrictions on bank holding companies.

### **Federal Securities Law**

The stock of First PacTrust Bancorp, Inc. is registered with the SEC under the Securities Exchange Act of 1934, as amended. The Company will be subject to the information, proxy solicitation, insider trading restrictions and other requirements of the SEC under the Securities Exchange Act of 1934.

Company stock held by persons who are affiliates of the Company may not be resold without registration unless sold in accordance with certain resale restrictions. Affiliates are generally considered to be officers, directors and principal stockholders. If the Company meets specified current public information requirements, each affiliate of the Company will be able to sell in the public market, without registration, a limited number of shares in any three-month period.

### **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 and Super NOW checking accounts. At December 31, 2007, Pacific Trust Bank was in compliance with these reserve requirements. The balances maintained to meet the reserve requirements imposed by the Federal Reserve Board may be used to satisfy liquidity requirements that may be imposed by the Office of Thrift Supervision. See Liquidity.

Savings institutions are authorized to borrow from the Federal Reserve Bank discount window, but Federal Reserve Board regulations require institutions to exhaust other reasonable alternative sources of funds, including Federal Home Loan Bank borrowings, before borrowing from the Federal Reserve Bank.

### **Federal Home Loan Bank System**

Pacific Trust Bank is a member of the Federal Home Loan Bank of San Francisco, which is one of 12 regional Federal Home Loan Banks, that administers the home financing credit function of savings institutions. Each Federal Home Loan Bank serves as a reserve or central bank for its members within its assigned region. It is funded primarily from proceeds derived from the sale of consolidated obligations of the Federal Home Loan Bank System. It makes loans or advances to members in accordance with policies and procedures, established by the board of directors of the Federal Home Loan Bank, which are subject to the oversight of the Federal Housing Finance Board. All advances from the Federal Home Loan Bank are required to be fully secured by sufficient collateral as determined by the Federal Home Loan Bank. In addition, all long-term advances are required to provide funds for residential home financing.

As a member, the Bank is required to purchase and maintain stock in the Federal Home Loan Bank of San Francisco. At December 31, 2007, the Bank had \$6.8 million in Federal Home Loan Bank stock, which was in compliance with this requirement. In past years, the Bank has received substantial dividends on its Federal Home Loan Bank stock. Over the past three fiscal years such dividends have averaged 5.00% and averaged 5.10% for 2007.

For the year ended December 31, 2007, dividends paid by the Federal Home Loan Bank of San Francisco to the Bank totaled \$436 thousand as compared to \$462 thousand for 2006.



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**TAXATION**

**Federal Taxation**

**General.** First PacTrust Bancorp, Inc. and Pacific Trust Bank is subject to federal income taxation in the same general manner as other corporations, with some exceptions discussed below. The following discussion of federal taxation is intended only to summarize certain pertinent federal income tax matters and is not a comprehensive description of the tax rules applicable to the Company or the Bank. The Bank's federal income tax returns have never been audited. Prior to January 1, 2000, the Bank was a credit union, not generally subject to corporate income tax.

**Method of Accounting.** For federal income tax purposes, Pacific Trust Bank currently reports its income and expenses on the accrual method of accounting and uses a fiscal year ending on December 31, for filing its federal income tax return.

**Minimum Tax.** The Internal Revenue Code imposes an alternative minimum tax at a rate of 20% on a base of regular taxable income plus certain tax preferences, called alternative minimum taxable income. The alternative minimum tax is payable to the extent such alternative minimum taxable income is in excess of an exemption amount. Net operating losses can offset no more than 90% of alternative minimum taxable income. Certain payments of alternative minimum tax may be used as credits against regular tax liabilities in future years. Pacific Trust Bank has not been subject to the alternative minimum tax, nor does the Company have any such amounts available as credits for carryover.

**Net Operating Loss Carryovers.** A financial institution may carryback net operating losses to the preceding two taxable years and forward to the succeeding 20 taxable years. This provision applies to losses incurred in taxable years beginning after August 6, 1997. At December 31, 2007, Pacific Trust Bank had no net operating loss carryforwards for federal income tax purposes.

**Corporate Dividends-Received Deduction.** First PacTrust Bancorp, Inc. may eliminate from its income dividends received from the Bank as a wholly owned subsidiary of the Company if it elects to file a consolidated return with the Bank. The corporate dividends-received deduction is 100% or 80%, in the case of dividends received from corporations with which a corporate recipient does not file a consolidated tax return, depending on the level of stock ownership of the payor of the dividend. Corporations which own less than 20% of the stock of a corporation distributing a dividend may deduct 70% of dividends received or accrued on their behalf.

**State Taxation**

First PacTrust Bancorp, Inc. and Pacific Trust Bank are subject to the California corporate franchise (income) tax which is assessed at the rate of 10.84%. For this purpose, California taxable income generally means federal taxable income subject to certain modifications provided for in the California law.

**Executive Officers Who are Not Directors**

The business experience for at least the past five years for each of our executive officers who do not serve as directors is set forth below.

**James P. Sheehy.** Age 61 years. Mr. Sheehy serves as Executive Vice President, a position he has held since 1987, and Secretary and Treasurer for Pacific Trust Bank, and First PacTrust Bancorp, Inc. positions he has held since 1999 and 2002, respectively. He has been employed by Pacific Trust Bank since 1987.

**Melanie M. Stewart.** Age 47 years. Ms. Stewart is Executive Vice President of Lending at Pacific Trust Bank. She has served in this position since 1998, and started with Pacific Trust Bank in 1985.

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*Rachel M. Carrillo.* Age 37 years. Ms. Carrillo is Senior Vice President of Branch Operations. She has served in this capacity since 1998. Ms. Carrillo has served in various other capacities at Pacific Trust Bank since 1993.

*Regan J. Lauer.* Age 38 years. Ms. Lauer is currently serving as Senior Vice President Controller of Pacific Trust Bank, and of First PacTrust Bancorp, Inc. a position she has held since 2000 and 2002, respectively. Prior to her position with Pacific Trust, Ms. Lauer was an Accountant with Deloitte.

*Lisa R. Goodwin.* Age 38 years. Ms. Goodwin is currently serving as Senior Vice President Information Systems at Pacific Trust Bank, a position she has held since 2001. Prior to serving as Vice President of Information Systems, Ms. Goodwin was an Assistant Vice President, and has been employed by Pacific Trust Bank since 1997. Prior to her position with Pacific Trust, Ms. Goodwin was an Associate Systems Engineer with Security Pacific Financial Services, a Bank of America Company, from 1993 to 1997.

**Item 1A. Risk Factors**

The following are certain risk factors that could impact our business, financial results and results of operations. Investing in our common stock involves risks, including those described below. These risk factors should be considered by prospective and current investors in our common stock when evaluating the disclosures in this Annual Report on Form 10-K (particularly the forward-looking statements.) These risk factors could cause actual results and conditions to differ materially from those projected in forward-looking statements. If the risks the Company faces, including those listed below, actually occur, our business, financial condition or results of operations could be negatively impacted, and the trading price of our common stock could decline, which may cause you to lose all or part of your investment.

**Economic changes may adversely affect the financial condition of the Company.**

If economic conditions continue to deteriorate, our results of operations and financial condition could continue to be adversely impacted as borrowers' ability to repay loans declines and the value of the collateral securing our loans decreases.

Our financial results may be adversely affected by changes in prevailing economic conditions, including decreases in real estate values, changes in interest rates which may cause a decrease in interest rate spreads, adverse employment conditions, the monetary and fiscal policies of the federal government and other significant external events. Because we have a significant amount of real estate loans, decreases in real estate values could adversely affect the value of property used as collateral. Adverse changes in the economy may also have a negative effect on the ability of our borrowers to make timely repayments of their loans, which would have an adverse impact on our earnings. In this regard, approximately 95% of our loans are to individuals and businesses in southern California. California, in general, and more specifically, San Diego, are considered to be amongst the most severely distressed real estate markets in the country. The rate of unemployment increased in San Diego County from 3.7% at December, 2006 to 4.9% at December, 2007 and from 4.6% to 6.6%, respectively, in Riverside County over the corresponding time frame, based on reported preliminary data for 2007.

**Rising interest rates may hurt the Company's profits.**

If interest rates rise, our net interest income and the value of our assets could be reduced if interest paid on interest-bearing liabilities, such as deposits and borrowings, increases more quickly than interest received on interest-earning assets, such as loans, mortgage-related and investment securities. For example, if we experienced an immediate 100 basis point rise in interest rates as of December 31, 2007, the market value of our portfolio equity could decrease by \$3.2 million. See Item 7A Quantitative and Qualitative Disclosures About Market Risk. In addition, rising interest rates may hurt our income because they may reduce the demand for loans and the value of our securities.

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### **The loan portfolio possesses increased risk due to the number of multi-family, construction, commercial real estate and consumer loans.**

Our multi-family, commercial real estate and consumer loans accounted for approximately 38.2% of our total loan portfolio as of December 31, 2007. Generally, we consider these types of loans to involve a higher degree of risk compared to first mortgage loans on one- to four-family, owner-occupied residential properties. In addition, we plan to increase our emphasis on multi-family and commercial real estate lending. Because of our planned increased emphasis on and increased investment in multi-family and commercial real estate lending, it may become necessary to increase the level of our provision for loan losses, which could hurt our profits. At December 31, 2007, the Company had \$18.9 million in construction loans outstanding, representing less than 3% of our gross loan portfolio. The Company does not expect construction loan originations to increase during the coming year.

### **The loan portfolio possesses increased risk due to expansion, unseasoned nature and amount of nonconforming loans.**

Over the last three years our loan portfolio has grown by \$81.4 million or 12.9%. As a result of this growth, a portion of our portfolio is considered to be unseasoned, with the risk that these loans may not have had sufficient time to perform to properly indicate the potential magnitude of losses. Our unseasoned adjustable rate loans have not, therefore, been subject to an interest rate environment which causes them to adjust to the maximum level and may involve risks resulting from potentially increasing payment obligations by the borrower as a result of repricing. Most of our adjustable rate mortgage loans are also non-conforming, due mainly to the generally large loan size and are, therefore, not readily saleable to Freddie Mac or Fannie Mae. Since some of these loans have terms which may result in negative amortization, where the loan payments do not fully cover interest expense and result in an increasing loan principal balance, the portfolio is also subject to increased risk of delinquency or default as the higher, fully indexed rate of interest subsequently comes into effect upon repricing.

### **Strong competition within the Company's market area may limit our growth and profitability.**

Competition in the banking and financial services industry is intense. In our market area, we compete with commercial banks, savings institutions, mortgage brokerage firms, credit unions, finance companies, mutual funds, insurance companies, and brokerage and investment banking firms operating locally and elsewhere. Many of these competitors have substantially greater resources and lending limits than we do and may offer certain services that we do not or cannot provide. Our profitability depends upon our continued ability to successfully compete in our market.

### **The amount of common stock we control, our charter and bylaws, and state and federal statutory provisions could discourage hostile acquisitions of control.**

Our board of directors and executive officers own approximately 12.65% of our common stock (as of December 31, 2007). In addition, the 401(k) Employee Stock Ownership Plan, as well as the restricted stock plan and the common stock underlying the stock option plan, has resulted in inside ownership of First PacTrust Bancorp, Inc. in excess of 27.41% of the total shares outstanding (including unallocated ESOP shares). This level of inside ownership and the provisions in our charter and bylaws may have the effect of discouraging attempts to acquire First PacTrust Bancorp, Inc., pursue a proxy contest for control of First PacTrust Bancorp, Inc., or to assume control of First PacTrust Bancorp, Inc. by a holder of a large block of common stock and remove First PacTrust Bancorp, Inc.'s management, all of which certain stockholders might think are in their best interests. The charter and bylaw provisions include, among other things:

the staggered terms of the members of the board of directors;

an 80% shareholder vote requirement for the approval of any merger or consolidation of First PacTrust Bancorp, Inc. into any entity that directly or indirectly owns 5% or more of First PacTrust Bancorp, Inc. voting stock if the transaction is not approved in advance by at least a majority of the disinterested members of First PacTrust Bancorp, Inc.'s board of directors;

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supermajority shareholder vote requirements for the approval of certain amendments to First PacTrust Bancorp, Inc.'s charter and bylaws;

a prohibition on any holder of common stock voting more than 10% of the outstanding common stock;

elimination of cumulative voting by shareholders in the election of directors;

restrictions on the acquisition of our equity securities; and

the authorization of 5,000,000 shares of preferred stock that could be issued without shareholder approval on terms or in circumstances that could deter a future takeover attempt.

In addition, the Maryland business corporation law, the state where First PacTrust Bancorp, Inc. is incorporated, provides for certain restrictions on acquisition of First PacTrust Bancorp, Inc., and federal law contains restrictions on acquisitions of control of savings and loan holding companies such as First PacTrust Bancorp, Inc.

**Item 1B. Unresolved Staff Comments**

None.

**Table of Contents****Item 2. Properties**

At December 31, 2007, the Bank had six full service offices and three limited service offices. The Bank owns the office building in which our home office and executive offices are located. At December 31, 2007, the Bank owned all but four of our other branch offices. The net book value of the Bank's investment in premises, equipment and leaseholds, excluding computer equipment, was approximately \$4.5 million at December 31, 2007.

The following table provides a list of Pacific Trust Bank's main and branch offices and indicates whether the properties are owned or leased:

| Location  | Owned or Leased | Lease Expiration Date | Net Book Value at December 31, 2007 (Dollars in Thousands) |
|---|-----------------|-----------------------|--|
| MAIN AND EXECUTIVE OFFICE<br>610 Bay Boulevard<br>Chula Vista, CA 91910 | Owned           | N/A                   | \$ 711   |
| BRANCH OFFICES:<br>279 F Street<br>Chula Vista, CA 91912                | Owned           | N/A                   | \$ 487   |
| 850 Lagoon Drive<br>Chula Vista, CA 91910                               | *               | N/A                   | N/A  |
| 350 Fletcher Parkway<br>El Cajon, CA 91910                              | Leased          | December, 2009        | N/A  |
| 5508 Balboa Avenue<br>San Diego, CA 92111                               | Leased          | October, 2011         | N/A  |
| 27425 Ynez Road<br>Temecula, CA 92591                                   | Owned           | N/A                   | \$ 779   |
| 8200 Arlington Avenue<br>Riverside, CA 92503                            | *               | N/A                   | N/A  |
| 5030 Arlington Avenue<br>Riverside, CA 92503                            | Owned           | N/A                   | \$ 236   |
| 16536 Bernardo Center Drive<br>San Diego, CA                            | Leased          | December, 2013        | N/A  |

\* This site, which is on a Goodrich Aerostructures facility, is provided to the Company at no cost as an accommodation to their employees. The Bank believes that our current facilities are adequate to meet the present and immediately foreseeable needs of Pacific Trust Bank and First PacTrust Bancorp, Inc.; however, the Company is currently evaluating additional branch offices.

**Item 3. Legal Proceedings**

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From time to time we are involved as plaintiff or defendant in various legal actions arising in the normal course of business. We do not anticipate incurring any material liability as a result of such litigation.

### **Item 4. Submission of Matters to a Vote of Security Holders**

No matter was submitted to a vote of security holders, through the solicitation of proxies or otherwise, during the quarter ended December 31, 2007.

**Table of Contents****PART II****Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities**

The Company's common stock is traded on the Nasdaq Global Market under the symbol FPTB. The approximate number of holders of record of the Company's common stock as of December 31, 2007 was 240. Certain shares of the Company are held in nominee or street name and accordingly, the number of beneficial owners of such shares is not known or included in the foregoing number. At March 7, 2008 there were 4,372,238 shares of common stock (net of Treasury stock) issued and outstanding. The following table presents quarterly market information for the Company's common stock for the two years ended December 31, 2007 and December 31, 2006.

| 2007               | Market Price Range |          | Dividends |
|--------------------|--------------------|----------|-----------|
|                    | High               | Low      |           |
| Quarter Ended      |                    |          |           |
| December 31, 2007  | \$ 25.61           | \$ 18.21 | \$ .185   |
| September 30, 2007 | \$ 26.00           | \$ 21.48 | \$ .185   |
| June 30, 2007      | \$ 27.50           | \$ 24.12 | \$ .185   |
| March 31, 2007     | \$ 28.08           | \$ 25.86 | \$ .180   |
|                    |                    |          | \$ .735   |
| 2006               | Market Price Range |          | Dividends |
|                    | High               | Low      |           |
| Quarter Ended      |                    |          |           |
| December 31, 2006  | \$ 28.41           | \$ 27.71 | \$ .17    |
| September 30, 2006 | \$ 28.92           | \$ 27.68 | \$ .16    |
| June 30, 2006      | \$ 29.75           | \$ 27.65 | \$ .155   |
| March 31, 2006     | \$ 30.51           | \$ 27.21 | \$ .145   |
|                    |                    |          | \$ .63    |

**DIVIDEND POLICY**

Dividends from First PacTrust Bancorp, Inc., will depend, in large part, upon receipt of dividends from Pacific Trust Bank, because First PacTrust Bancorp, Inc. will have limited sources of income other than dividends from Pacific Trust Bank, earnings from the investment of proceeds from the sale of shares of common stock retained by First PacTrust Bancorp, Inc., and interest payments with respect to First PacTrust Bancorp, Inc.'s loan to the 401(k) Employee Stock Ownership Plan. During fiscal 2007, a \$3.3 million dividend was paid from the Bank to First PacTrust Bancorp, Inc. A regulation of the Office of Thrift Supervision imposes limitations on capital distributions by savings institutions. See How We Are Regulated Limitations on Dividends and Other Capital Distributions.

**Table of Contents****ISSUER PURCHASES OF EQUITY SECURITIES**

| <b>Period</b>    | <b>Total # of shares<br/>Purchased</b> | <b>Average price paid<br/>per share</b> | <b>Total # of shares<br/>purchased as<br/>part of a publicly<br/>announced program</b> | <b>Maximum # of<br/>shares that may<br/>yet be purchased</b> |
|------------------|--|---|--|--|
| 10/1/07-10/31/07 |  |   |  | 0  |
| 11/1/07-11/30/07 |  |   |  | 0  |
| 12/1/07-12/31/07 | 4,960                                  | 18.37                                   | 4,960  | 0  |

During 2007 a buyback plan was not approved by the Company's board of directors, however a 4,558 share purchase was made during the quarter ended December 31, 2007, as a result of an annual customary purchase of forfeited ESOP shares and a total of 402 shares were repurchased from insiders as payment of related tax liability in lieu of cash by delivering or withholding securities incident to vesting of securities issued in accordance with Rule 16b-3. As of January 23, 2008, a new buyback plan totaling 150,000 shares was authorized by the Company's board of directors to be conducted at prevailing market prices. A total of 32,300 shares were purchased in 2008 under this authorized buyback plan.



**Table of Contents****Item 6. Selected Financial Data****SELECTED FINANCIAL AND OTHER DATA**

The following table sets forth certain consolidated financial and other data of the Company at the dates and for the periods indicated. The information set forth below should be read in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operation included herein at Item 7 and the consolidated financial statements and notes thereto included herein at Item 8.

|  | 2007                                  | 2006       | December 31,<br>2005 | 2004       | 2003       |
|--|---------------------------------------|------------|----------------------|------------|------------|
|  | (In thousands, except per share data) |            |                      |            |            |
| <b>Selected Financial Condition Data:</b>  |                                       |            |                      |            |            |
| Total assets   | \$ 774,720                            | \$ 808,343 | \$ 755,177           | \$ 674,460 | \$ 623,964 |
| Cash and cash equivalents  | 21,796                                | 13,995     | 13,873               | 12,315     | 11,575     |
| Loans receivable, net  | 710,095                               | 740,044    | 688,497              | 628,724    | 587,251    |
| Securities available-for-sale  | 4,367                                 | 13,989     | 14,012               | 10,019     | 6,419      |
| Bank owned life insurance  | 17,042                                | 16,349     | 15,675               |            |            |
| Other investments (interest-bearing term deposit)                                | 992                                   | 992        | 1,507                | 2,490      | 500        |
| FHLB stock   | 6,842                                 | 9,794      | 8,523                | 7,784      | 8,293      |
| Deposits   | 574,151                               | 570,543    | 508,156              | 453,581    | 389,925    |
| Total borrowings   | 111,700                               | 151,200    | 164,200              | 135,500    | 147,000    |
| Total equity   | 84,075                                | 81,741     | 77,769               | 79,391     | 84,539     |
| <b>Selected Operations Data:</b>   |                                       |            |                      |            |            |
| Total interest income  | 45,711                                | 45,514     | 35,651               | 31,733     | 27,721     |
| Total interest expense   | 28,847                                | 26,945     | 16,703               | 11,426     | 9,159      |
| Net interest income  | 16,864                                | 18,569     | 18,948               | 20,307     | 18,562     |
| Provision for loan losses  | 1,588                                 | (24)       | 250                  | 238        | 1,272      |
| Net interest income after provision for loan losses                              | 15,276                                | 18,593     | 18,698               | 20,069     | 17,290     |
| Customer service charges   | 1,573                                 | 1,397      | 1,266                | 1,219      | 1,092      |
| Net gain on sales of securities available-for-sale                               |                                       |            | 18                   | 93         |            |
| Income from bank owned life insurance  | 711                                   | 628        | 675                  |            |            |
| Other non-interest income  | 107                                   | 192        | 185                  | 238        | 189        |
| Total non-interest income  | 2,391                                 | 2,217      | 2,144                | 1,550      | 1,281      |
| Total non-interest expense   | 14,082                                | 13,565     | 13,410               | 12,658     | 11,510     |
| Income before taxes  | 3,585                                 | 7,245      | 7,432                | 8,961      | 7,061      |
| Income tax provision   | 624                                   | 2,531      | 2,625                | 3,886      | 2,960      |
| Net income   | 2,961                                 | 4,714      | 4,807                | 5,075      | 4,101      |
| Basic earnings per share   | .71                                   | 1.15       | 1.16                 | 1.18       | .86        |
| Diluted earnings per share   | .70                                   | 1.12       | 1.13                 | 1.16       | .85        |
| <b>Selected Financial Ratios and Other Data:</b>                                 |                                       |            |                      |            |            |
| <i>Performance Ratios:</i>   |                                       |            |                      |            |            |
| Return on assets (ratio of net income to average total assets)                   | 0.38%                                 | 0.59%      | 0.67%                | 0.77%      | 0.74%      |
| Return on equity (ratio of net income to average equity)                         | 3.54%                                 | 5.91%      | 6.10%                | 6.32%      | 4.66%      |
| Dividend payout ratio  | 109.3%                                | 58.9%      | 49.7%                | 39.1%      | 33.3%      |
| <i>Interest Rate Spread Information:</i>   |                                       |            |                      |            |            |
| Average during period  | 1.89%                                 | 2.11%      | 2.49%                | 2.90%      | 3.17%      |
| End of period  | 2.18%                                 | 1.78%      | 2.34%                | 2.85%      | 2.82%      |
| Net interest margin(1)   | 2.27%                                 | 2.44%      | 2.76%                | 3.16%      | 3.49%      |
| Ratio of operating expense to average total assets                               | 1.81%                                 | 1.70%      | 1.86%                | 1.92%      | 2.09%      |
| Efficiency ratio(2)  | 73.13%                                | 65.26%     | 63.63%               | 56.73%     | 58.01%     |
| Ratio of average interest-earning assets to average interest-bearing Liabilities | 109.84%                               | 109.15%    | 111.1%               | 114.72%    | 118.23%    |



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|  | 2007   | 2006    | December 31,<br>2005<br>(In thousands) | 2004     | 2003     |
|--|--------|---------|--|----------|----------|
| <i>Quality Ratios:</i>                               |        |         |  |          |          |
| Non-performing assets to total assets                | 1.82%  | 0.24%   | %                                      | %        | %        |
| Allowance for loan losses to non-performing loans(3) | 44.16% | 239.24% | 156,367%                               | 110,750% | 423,200% |
| Allowance for loans losses to gross loans(3)         | 0.87%  | 0.63%   | 0.68%                                  | 0.70%    | 0.72%    |
| <i>Capital Ratios:</i>                               |        |         |  |          |          |
| Equity to total assets at end of period              | 10.9%  | 10.1%   | 10.3%                                  | 11.8%    | 13.6%    |
| Average equity to average assets                     | 10.7%  | 10.0%   | 11.0%                                  | 12.2%    | 16.0%    |
| <i>Other Data:</i>                                   |        |         |  |          |          |
| Number of full-service offices                       | 6      | 6       | 6                                      | 6        | 6        |

- (1) Net interest income divided by average interest-earning assets.
- (2) Efficiency ratio represents noninterest expense as a percentage of net interest income plus noninterest income, exclusive of securities gains and losses and an impairment loss in 2004.
- (3) The allowance for loan losses at December 31, 2007, 2006, 2005, 2004, and 2003 was \$6.2 million, \$4.7 million, \$4.7 million, \$4.4 million, and \$4.2 million, respectively.

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

#### **Executive Management Overview**

This overview of management's discussion and analysis highlights selected information in the financial results of the Company and may not contain all of the information that is important to you. For a more complete understanding of trends, commitments, uncertainties, liquidity, capital resources and critical accounting policies and estimates, you should carefully read this entire document. Each of these items could have an impact on the Company's financial condition and results of operations.

First PacTrust Bancorp, Inc. is a savings and loan holding company that owns one thrift institution, Pacific Trust Bank. As a unitary thrift holding company, First PacTrust Bancorp, Inc. activities are limited to banking, securities, insurance and financial services-related activities. Pacific Trust Bank is a federally chartered stock savings bank, in continuous operation since 1941 as a profitable and successful financial institution. The Company is headquartered in Chula Vista, California, a suburb of San Diego, California, and has six full service and three limited service banking offices primarily serving residents of San Diego and Riverside Counties in California. The Company's geographic market for loans and deposits is principally San Diego and Riverside counties.

The Company's principal business consists of attracting retail deposits from the general public and investing these funds and other borrowings in loans primarily secured by first mortgages on owner-occupied, one-to four- family residences in San Diego and Riverside counties, California. At December 31, 2007, one- to four-family residential mortgage loans totaled \$421.1 million, or 59.0% of our gross loan portfolio. During 2005, the Company introduced a new lending product called the Green Account, America's first fully transactional flexible mortgage account. The Company experienced significant growth in this product during 2007 and originated \$139.6 million Green Account loans. The Company anticipates that growth in this product will continue.

The Company continues to develop strong deposit relationships with customers by providing quality service while offering a variety of competitive deposit products. During 2007, the Company introduced commercial deposit accounts and had \$12.8 million of commercial deposit accounts at December 31, 2007. Total net deposits increased \$3.6 million primarily in the Company's high yield savings and certificate of deposit accounts due to customers shifting their funds into higher yielding accounts.

The Company's results of operations are dependent primarily on net interest income, which is the difference between interest income on earning assets such as loans and securities, and interest expense paid on liabilities such as deposits and borrowings. The past year proved to be an extremely challenging operating environment given the deterioration in the housing and credit markets along with the unsustainably high deposit pricing. The Company's interest income, which is primarily driven by interest income on residential first mortgage loans, increased by \$197 thousand for the year ended December 31, 2007. Relatively low mid- to long-term interest rate levels experienced throughout the year negatively impacted interest income by continuing to fuel significant prepayments and refinancing of higher yielding loans. However, current market conditions, including declining short term interest rates, are starting to have a positive effect on the Company's yield on earning assets versus deposit costs in 2008. Margins on jumbo loans, which the Company specializes in, have increased in 2008 and, therefore, the Company expects an abatement to the margin compression in the coming year.

Future earnings of the Company are inherently tied to changes in interest rate levels, the relationship between short and long term interest rates, credit quality, and economic trends. If short term interest rates continue to decrease, the Company's interest expense on deposits will likely decrease at a faster pace than the interest income received on earning assets due to the relatively shorter term repricing characteristics of the Company's deposits than the maturity or repricing characteristics of its loan portfolio. The Company intends to continue to focus on the origination of adjustable rate loan products while securing longer term deposits and borrowings.

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The plan for our on-going success is continued leveraging of the Company's assets, mostly through continued loan portfolio and deposit growth to make better use of our current relatively high capital ratios. This growth is intended to be funded with deposit growth and borrowed funds if needed with terms that are appropriate to manage interest rate risk while assuring an adequate net interest spread. The Company will continue its strategy of loan and deposit portfolio growth through high-quality customer service and the development and introduction of innovative financial products. This will be coupled with efforts to further improve our efficiency ratio through controlled operating expense growth, as well as exploring potential new sources of noninterest income. The Company continues to look for opportunities to open an additional branch location in San Diego County if the right location can be found. Given the difficult operating environment during 2007 and in order to prevent further margin compression, the Company did not aggressively pursue one-to four-family loan originations. However, margins on real estate jumbo loans, in which the Company specializes in, have begun to widen in 2008 and the Company plans to pursue growth in these loans.

*The following is a discussion and analysis of the Company's financial position and results of operations and should be read in conjunction with the information set forth under "General" in Item 7A, "Quantitative and Qualitative Disclosures about Market Risk," and the consolidated financial statements and notes thereto appearing under Item 8 of this report. Dollar amounts are in thousands with the exception of share and per share data.*

**Comparison of Financial Condition at December 31, 2007 and December 31, 2006**

The Company's total assets decreased by \$33.6 million, or 4.2%, to \$774.7 million at December 31, 2007 from \$808.3 million at December 31, 2006. The decrease primarily reflected a reduction in the balance of loans receivable in the amount of \$29.9 million.

Net loans receivable decreased by \$29.9 million, or 4.1%, to \$710.1 million at December 31, 2007 from \$740.0 million at December 31, 2006. The decrease in loans resulted primarily from repayments exceeding loan originations during the year as loan production substantially decreased from the prior period. One-to four-family loans decreased \$94.8 million and commercial and multi-family loans decreased \$13.4 million. In order to prevent further margin compression, the Bank has not been aggressively pursuing one-to four-family loans. Loan balances in the Company's transactional flexible mortgage loan product, which is included in the home equity balance, increased \$75.2 million, construction loans increased \$2.5 million and land loans increased \$1.6 million. Loan production of \$222.0 million year-to-date was primarily attributable to \$139.6 million of originations of the Company's Green Account. Growth in the Company's Green Account is expected to continue. At December 31, 2007, the Company had a total of \$294.3 million in interest-only mortgage loans, \$164.0 million in interest-only transactional flexible mortgage loans and \$48.2 million in loans with potential for negative amortization. At December 31, 2006, the Company had a total of \$343.0 million in interest-only mortgage loans, \$87.3 million in interest-only transactional flexible mortgage loans and \$77.8 million in loans with potential for negative amortization. These loans could pose a higher credit risk because of the lack of principal amortization and potential for negative amortization. However, management believes the risk is mitigated through the Company's loan terms and underwriting standards, including its policies on loan-to-value ratios. Additionally, the Company no longer originates negatively amortizing loans.

Securities classified as available-for-sale of \$4.4 million at December 31, 2007 decreased \$9.6 million from December 31, 2006 due to the sale of two agency securities during the period at par.

Total deposits increased by \$3.6 million, or 0.6%, to \$574.2 million at December 31, 2007 from \$570.5 million at December 31, 2006. Deposits increased as a result of marketing efforts and newly originated business deposits and primarily reflected growth in savings and certificate of deposit accounts. Savings accounts increased \$37.2 million, or 85.6%, to \$80.6 million, chiefly in the Company's high yield savings account due to competitive rate terms. Certificates of deposit increased \$15.0 million or 5.2% to \$305.1 million due also to competitive rate terms. Money market accounts decreased \$40.2 million or 23.7% to \$129.5 million and NOW

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accounts decreased \$11.8 million or 22.3% to \$41.1 million due to customers shifting their funds into higher yielding products of the Company. Due to the increase in retail deposit balances and the reduction in outstanding loans, the Bank became less reliant on wholesale funding including Federal Home Loan Bank advances, which decreased \$39.5 million to \$111.7 million, and brokered certificates of deposit, which decreased \$17.9 million to \$3.8 million at December 31, 2007.

Equity increased \$2.3 million to \$84.1 million at December 31, 2007 from \$81.7 million at December 31, 2006. The net increase resulted primarily from net income of \$3.0 million, ESOP shares earned of \$1.0 million, stock awards earned of \$686 thousand, and an increase in retained earnings in the amount of \$328 thousand, resulting from the adoption of the new accounting standard FIN 48. Equity decreased primarily as a result of the payment of dividends of \$3.1 million and the purchase of treasury stock in the amount of \$403 thousand.

**Table of Contents****Average Balances, Net Interest Income, Yields Earned and Rates Paid**

The following table presents for the periods indicated the total dollar amount of interest income from average interest-earning assets and the resultant yields, as well as the interest expense on average interest-bearing liabilities, expressed both in dollars and rates. Also presented is the weighted average yield on interest-earning assets, rates paid on interest-bearing liabilities and the resultant spread at December 31, 2007. No tax equivalent adjustments were made. All average balances are monthly average balances. Non-accruing loans have been included in the table as loans carrying a zero yield.

|   | At December 31,<br>2007                             |                    | 2007             |                           | 2006               |                  | 2005                      |                    |                  |                           |
|---|---|--------------------|------------------|---------------------------|--------------------|------------------|---------------------------|--------------------|------------------|---------------------------|
|   | Average<br>Yield/ Cost<br>(Dollars in<br>thousands) | Average<br>Balance | Interest         | Average<br>Yield/<br>Cost | Average<br>Balance | Interest         | Average<br>Yield/<br>Cost | Average<br>Balance | Interest         | Average<br>Yield/<br>Cost |
| <b>INTEREST-EARNING</b>                       |   |                    |                  |                           |                    |                  |                           |                    |                  |                           |
| <b>ASSETS</b>                                 |   |                    |                  |                           |                    |                  |                           |                    |                  |                           |
| Loans receivable(1)                           | 6.46%   | \$ 713,548         | \$ 44,632        | 6.25%                     | \$ 730,006         | \$ 44,202        | 6.06%                     | \$ 654,317         | \$ 34,510        | 5.27%                     |
| Securities(2)                                 | 4.99%   | 12,789             | 567              | 4.43%                     | 14,307             | 627              | 4.38%                     | 14,007             | 623              | 4.45%                     |
| Other interest-earning<br>assets(3)           | .94%  | 17,378             | 512              | 2.95%                     | 18,205             | 685              | 3.76%                     | 17,399             | 518              | 2.98%                     |
| <b>Total interest-earning<br/>assets</b>      | <b>6.28%</b>  | <b>743,715</b>     | <b>45,711</b>    | <b>6.16%</b>              | <b>762,518</b>     | <b>45,514</b>    | <b>5.97%</b>              | <b>685,723</b>     | <b>35,651</b>    | <b>5.20%</b>              |
| Non-interest earning<br>assets(4)             |   | 36,199             |                  |                           | 35,178             |                  |                           | 33,618             |                  |                           |
| <b>Total assets</b>                           |   | <b>\$ 779,914</b>  |                  |                           | <b>\$ 797,696</b>  |                  |                           | <b>\$ 719,341</b>  |                  |                           |
| <b>INTEREST-BEARING</b>                       |   |                    |                  |                           |                    |                  |                           |                    |                  |                           |
| <b>LIABILITIES</b>                            |   |                    |                  |                           |                    |                  |                           |                    |                  |                           |
| NOW   | 1.69%   | 45,570             | 768              | 1.69%                     | 54,913             | 961              | 1.75%                     | 65,685             | 959              | 1.46%                     |
| Money market                                  | 3.59%   | 167,888            | 7,280            | 4.34%                     | 155,448            | 6,744            | 4.34%                     | 96,860             | 2,569            | 2.65%                     |
| Savings deposits                              | 3.26%   | 54,436             | 1,353            | 2.49%                     | 51,668             | 854              | 1.65%                     | 63,081             | 998              | 1.58%                     |
| Certificates of deposit                       | 4.97%   | 294,612            | 14,461           | 4.91%                     | 259,771            | 11,024           | 4.24%                     | 237,598            | 7,606            | 3.20%                     |
| FHLB advances                                 | 3.83%   | 114,562            | 4,985            | 4.35%                     | 176,769            | 7,362            | 4.16%                     | 154,262            | 4,571            | 2.96%                     |
| <b>Total interest-bearing<br/>liabilities</b> | <b>4.10%</b>  | <b>677,068</b>     | <b>28,847</b>    | <b>4.26%</b>              | <b>698,569</b>     | <b>26,945</b>    | <b>3.86%</b>              | <b>617,486</b>     | <b>16,703</b>    | <b>2.71%</b>              |
| Non-interest-bearing<br>liabilities           |   | 19,319             |                  |                           | 19,336             |                  |                           | 23,086             |                  |                           |
| <b>Total liabilities</b>                      |   | <b>696,387</b>     |                  |                           | <b>717,905</b>     |                  |                           | <b>640,572</b>     |                  |                           |
| <b>Equity</b>                                 |   | <b>83,527</b>      |                  |                           | <b>79,791</b>      |                  |                           | <b>78,769</b>      |                  |                           |
| <b>Total liabilities and<br/>equity</b>       |   | <b>\$ 779,914</b>  |                  |                           | <b>\$ 797,696</b>  |                  |                           | <b>\$ 719,341</b>  |                  |                           |
| <b>Net interest/spread</b>                    | <b>2.18%</b>  |                    | <b>\$ 16,864</b> | <b>1.89%</b>              |                    | <b>\$ 18,569</b> | <b>2.11%</b>              |                    | <b>\$ 18,948</b> | <b>2.49%</b>              |
| <b>Margin(5)</b>                              |   |                    |                  | <b>2.27%</b>              |                    |                  | <b>2.44%</b>              |                    |                  | <b>2.76%</b>              |
|   |   | <b>109.84%</b>     |                  |                           | <b>109.15%</b>     |                  |                           | <b>111.05%</b>     |                  |                           |

Ratio of  
interest-earning assets  
to interest-bearing  
liabilities

- (1) Calculated net of deferred fees and loss reserves.
- (2) Calculated based on amortized cost.
- (3) Includes FHLB stock at cost and term deposits with other financial institutions.
- (4) Includes BOLI investment of \$17.0 million.
- (5) Net interest income divided by interest-earning assets.



**Table of Contents****Rate/Volume Analysis**

The following table presents the dollar amount of changes in interest income and interest expense for major components of interest-earning assets and interest-bearing liabilities. For each category of interest-earning assets and interest-bearing liabilities, information is provided on changes attributable to (1) changes in volume, which are changes in volume multiplied by the old rate, and (2) changes in rate, which are changes in rate multiplied by the old volume. Changes attributable to both rate and volume which cannot be segregated have been allocated proportionately to the change due to volume and the change due to rate.

|   | 2007 Compared to 2006 |                      |                    | 2006 Compared to 2005 |                      |                    |
|---|-----------------------|----------------------|--------------------|-----------------------|----------------------|--------------------|
|   | Total Change          | Change Due To Volume | Change Due To Rate | Total Change          | Change Due To Volume | Change Due To Rate |
| <b>INTEREST-EARNING ASSETS</b>            |                       |                      |                    |                       |                      |                    |
| Loans receivable                          | \$ 430                | \$ (1,010)           | \$ 1,440           | \$ 9,692              | \$ 4,251             | \$ 5,441           |
| Securities                                | (60)                  | (67)                 | 7                  | 4                     | 13                   | (9)                |
| Other interest-earning assets             | (173)                 | (30)                 | (143)              | 167                   | 25                   | 142                |
| <b>Total interest-earning assets</b>      | <b>\$ 197</b>         | <b>\$ (1,107)</b>    | <b>\$ 1,304</b>    | <b>\$ 9,863</b>       | <b>\$ 4,289</b>      | <b>\$ 5,574</b>    |
| <b>INTEREST-BEARING LIABILITIES</b>       |                       |                      |                    |                       |                      |                    |
| NOW                                       | \$ (193)              | \$ (159)             | \$ (34)            | \$ 2                  | \$ (171)             | \$ 173             |
| Money market                              | 536                   | 539                  | (3)                | 4,175                 | 2,036                | 2,139              |
| Savings deposits                          | 499                   | 48                   | 451                | (144)                 | (187)                | 43                 |
| Certificates of deposit                   | 3,437                 | 1,585                | 1,852              | 3,418                 | 761                  | 2,657              |
| FHLB advances                             | (2,377)               | (2,694)              | 317                | 2,791                 | 738                  | 2,053              |
| <b>Total interest-bearing liabilities</b> | <b>1,902</b>          | <b>(681)</b>         | <b>2,583</b>       | <b>10,242</b>         | <b>3,177</b>         | <b>7,065</b>       |
| <b>Net interest/spread</b>                | <b>\$ (1,705)</b>     | <b>\$ (426)</b>      | <b>\$ (1,279)</b>  | <b>\$ (379)</b>       | <b>\$ 1,112</b>      | <b>\$ (1,491)</b>  |

**Comparison of Operating Results for the Years Ended December 31, 2007 and 2006**

**General.** Net income for the year ended December 31, 2007 was \$3.0 million, a decrease of \$1.7 million, or 37.2%, from \$4.7 million for the year ended December 31, 2006. The decrease in net income resulted primarily from an increase in the provision for loan losses and margin compression due to an increase in short term interest rates and a continued flattening and inversion of the yield curve as discussed below.

**Interest Income.** Interest income increased by \$197 thousand or .43%, to \$45.7 million for the year ended December 31, 2007 from \$45.5 million for the year ended December 31, 2006. The primary factor for the increase in interest income was an increase in the average yield on loans receivable of 19 basis points to 6.25% for the year ended December 31, 2007 compared to 6.06% for the year ending December 31, 2006, reflecting the overall increase in interest rates compared to the prior period. Interest income was partially reduced by a decrease in the average balance of loans receivable of \$16.5 million or 2.3% from \$730.0 million for the year ended December 31, 2006 to \$713.5 million for the year ended December 31, 2007. Interest income was also reduced as a result of reversed loan interest income in the amount of \$994 thousand related to loans on non-accrual status.

The Company has originated loans with potential for negative amortization since 2000 and had a balance of \$48.2 million at December 31, 2007. The Company is no longer offering loans with the potential for negative amortization. Capitalized interest recognized in earnings that resulted from negative amortization within the portfolio totaled \$1.6 million or 3.6% of loan interest income for the year ended December 31, 2007 and \$1.7 million or 3.9% of loan interest income for the year ended December 31, 2006. The Company has mitigated the risks associated with the negatively amortizing loans by using conservative underwriting standards and has experienced no losses to date related to these loans.

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Interest income on other interest-earning assets decreased \$173 thousand, or 25.3% to \$512 thousand for the year ended December 31, 2007 from \$685 thousand for the year ended December 31, 2006 primarily due to decreased FHLB stock dividends resulting from a decrease in the average balances of Federal Home Loan Bank stock due to a reduction in loan growth during the year.

Interest income on securities decreased \$60 thousand, or 9.6% to \$567 thousand for the year ended December 31, 2007 from \$627 thousand for the year ended December 31, 2006 due to the sale of two agency securities during the fourth quarter of 2007. The average yield on the securities portfolio increased by 5 basis points from 4.38% for the year ended December 31, 2006 to 4.43% for the year ended December 31, 2007.

**Interest Expense.** Interest expense increased \$1.9 million or 7.1%, to \$28.8 million for the year ended December 31, 2007 primarily due to an increase in interest expense on deposits reduced by a decrease in interest expense on Federal Home Loan Bank advances. Interest expense on deposits increased \$4.3 million, or 21.9% to \$23.9 million for the year ended December 31, 2007 from \$19.6 million. This resulted from a 40 basis point increase in the Company's cost of funds due to an increase in short term interest rates as well as a \$40.7 million increase in the average balance of deposits from \$521.8 million for the year ended December 31, 2006 to \$562.5 million for the year ended December 31, 2007. The average balance of deposits increased as a result of marketing efforts and newly originated business deposits. Interest expense on Federal Home Loan Bank advances decreased approximately \$2.4 million, or 32.3%, to \$5.0 million for the year ended December 31, 2007 from \$7.4 million for the year ended December 31, 2006 primarily due to a \$62.2 million decrease in the average balance of Federal Home Loan Bank advances as the company utilized the growth in deposit balances to fund loan demand which also decreased during the year. Although Federal Home Loan Bank advances substantially decreased during the year ended December 31, 2007, due to maturing lower cost fixed-rate advances, the average rate paid on Federal Home Loan Bank advances increased 19 basis points from the same period for the year ended December 31, 2006.

**Net Interest Income.** As a result of the factors mentioned above, net interest income before the provision for loan losses decreased \$1.7 million, or 9.2%, to \$16.9 million for the year ended December 31, 2007 from \$18.6 million for the year ended December 31, 2006. Due to the relatively flat, and at times, inverted yield curve environment and the resulting higher cost of funds in effect during the year, the Company's margins continued to tighten further with the net interest spread decreasing 22 basis points to 1.9% and the net interest margin decreasing 17 basis points to 2.3%.

**Provision for Loan Losses.** A provision for loan losses of \$1.6 million was recorded for the year ended December 31, 2007 compared to a \$24 thousand net reduction recorded for the year ended December 31, 2006. The increase in the provision for loan losses during the current year was primarily to increase the allowance for loan losses for two impaired loans. During the year ended December 31, 2007, the Company determined that a \$10.0 million construction loan was impaired and a specific loss allocation of \$1.6 million was established. The Company's construction loan portfolio, including the non-accrual construction loan, currently totals \$18.9 million or 2.7% of the Company's total loan portfolio.

In addition, a specific loss allocation of \$580 thousand was established in December, 2007 for one commercial non-real estate loan totaling \$775 thousand. This is the only loan of this type in the Company's portfolio. Year-to-date charge-offs totaled \$24 thousand and recoveries totaled \$6 thousand resulting in net charge-offs of \$18 thousand for the year ending December 31, 2007. For the same period of the prior year there were net recoveries of \$3 thousand. Total non-performing loans, including the two impaired loans mentioned above, totaled \$14.1 million at year end December 31, 2007 compared to \$2.0 million of non-performing loans for the year ended December 31, 2006. The allowance for loan losses as a percentage of loans outstanding was 0.87% at December 31, 2007 compared to 0.63% at December 31, 2006.

Provisions for loan losses are charged to operations at a level required to reflect probable incurred credit losses in the loan portfolio. In evaluating the level of the allowance for loan losses, management considers

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historical loss experience, the types of loans and the amount of loans in the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral, peer group information, declining property values and prevailing economic conditions. Large groups of smaller balance homogeneous loans, such as residential real estate, small commercial real estate, and home equity and consumer loans, are evaluated in the aggregate using historical loss factors and peer group data adjusted for current economic conditions. Large balance and/or more complex loans, such as multi-family, construction, and commercial real estate loans, and classified loans, are evaluated individually for impairment.

This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available or as future events change. The Company used the same methodology and generally similar assumptions in assessing the allowance for both periods. The level of the allowance is based on estimates and the ultimate losses may vary from the estimates.

Management assesses the allowance for loan losses quarterly. While management uses available information to recognize losses on loans, future loan loss provisions may be necessary based on changes in economic conditions. In addition, regulatory agencies, as an integral part of their examination process, periodically review the allowance for loan losses and may require the bank to recognize additional provisions based on their judgment of information available to them at the time of their examination. The allowance for loan losses as of December 31, 2007 was maintained at a level that represented management's best estimate of incurred losses in the loan portfolio to the extent they were both probable and reasonably estimable.

**Noninterest Income.** Noninterest income increased \$174 thousand, or 7.9% to \$2.4 million for the year ended December 31, 2007 from \$2.2 million for the year ended December 31, 2006, primarily due to increased customer service fees of \$180 thousand. During the third quarter of 2006, the Company adjusted various service fees to its customers resulting in increased service fee income for the current year. Additionally, bank owned life insurance income increased \$83 thousand to \$711 thousand for the year ended December 31, 2007 from \$628 thousand for the year ended December 31, 2006 due to improved performance of the investment. The net increase in noninterest income was reduced by an \$86 thousand decrease in prepayment penalties and miscellaneous decreases in various accounts.

**Noninterest Expense.** Noninterest expense increased \$517 thousand or 3.8%, to \$14.1 million for the year ended December 31, 2007 from \$13.6 million for the year ended December 31, 2006. This increase was primarily the result of a \$244 thousand increase in other general and administrative expenses, a \$172 thousand increase in data processing expenses, a \$119 thousand increase in professional fees and a \$117 thousand increase in the operating loss on the housing fund investment. Additionally, salaries and employee benefits decreased \$178 thousand.

Total other general and administrative expenses increased \$244 thousand, or 17.7%, to \$1.6 million for the year ended December 31, 2007 from \$1.4 million for the year ended December 31, 2006 primarily due to increased FDIC deposit insurance premiums assessed effective January, 2007 for all FDIC insured financial institutions.

Data processing cost increased \$172 thousand, or 20.2% to \$1.0 million for the year ended December 31, 2007 from \$853 thousand for the year ended December 31, 2006 due to increased software maintenance expenses and fees related to increased processing volume resulting from new commercial business accounts.

Professional fees increased \$119 thousand, or 28.9% to \$531 thousand for the year ended December 31, 2007 from \$412 thousand for the year ended December 31, 2006 primarily due to increased fees resulting from the analysis of various strategic alternatives.

The total loss on the California Affordable Housing Fund investment of \$512 thousand for the year ended December 31, 2007 increased \$117 thousand or 29.6% over the prior year's period primarily due to a revised loss

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adjustment recorded in the third quarter of 2007. A re-evaluation of the housing fund was completed by the issuing bank in September which resulted in higher than anticipated losses for the year due to the delay in construction in one of the underlying properties of the investment. The total yield on the investment is expected to remain unchanged at 6.40%, however, the tax losses associated with this particular property have been accelerated in 2007.

Salaries and employee benefits represented 51.6% and 54.9% of total noninterest expense for the year ended December 31, 2007 and December 31, 2006, respectively. Total salaries and employee benefits decreased \$178 thousand, or 2.4%, to \$7.3 million for the year ended December 31, 2007 from \$7.4 million for the same period in 2006 primarily due to lower bonus expenses resulting from lower net income.

**Income Tax Expense.** Income tax expense decreased \$1.9 million to \$624 thousand for the year ended December 31, 2007, from \$2.5 million for the year ended December 31, 2006 due to lower pre-tax income for the period. The effective tax rate was 17.4% and 34.9% for the years ended December 31, 2007 and 2006, respectively. The decrease in the effective tax rate was attributable to the tax exempt status of income from the BOLI investment purchased during the first quarter of 2005 and tax credits from the affordable housing fund investment made in December 2004.

**Comparison of Operating Results for the Years Ended December 31, 2006 and 2005**

**General.** Net income for the year ended December 31, 2006 was \$4.7 million, a decrease of \$93 thousand, or 1.9%, from \$4.8 million for the year ended December 31, 2005. The decrease in net income resulted primarily from continued margin compression due to an increase in short term interest rates and a continued flattening and inversion of the yield curve as discussed below.

**Interest Income.** Interest income increased by \$9.9 million or 27.7%, to \$45.5 million for the year ended December 31, 2006 from \$35.7 million for the year ended December 31, 2005. The primary factor for the increase in interest income was an increase in the average yield on loans receivable by 79 basis points to 6.06% for the year ended December 31, 2006 compared to 5.27% for the year ending December 31, 2005. In addition, total loans receivable increased \$75.7 million or 11.6% from \$654.3 million for the year ended December 31, 2005 to \$730.0 million for the year ended December 31, 2006. The growth was primarily the result of loan originations exceeding repayments during the year.

The Company has originated loans with potential for negative amortization since 2000 and currently has a balance of \$77.8 million at December 31, 2006 of such loans. Capitalized interest recognized in earnings that resulted from negative amortization within the portfolio totaled \$1.7 million or 3.9% of loan interest income for the year ended December 31, 2006 and \$519 thousand or 1.5% of loan interest income for the year ended December 31, 2005. The Company has mitigated the risks associated with the negatively amortizing loans by using conservative underwriting standards as evidenced by experiencing no losses related to these loans.

Interest income on other interest-earning assets increased \$167 thousand, or 32.2% to \$685 thousand for the year ended December 31, 2006 from \$518 thousand for the year ended December 31, 2005 primarily due to increased FHLB stock dividends resulting from an increase in the average balances of Federal Home Loan Bank stock during the year and higher dividend rates paid. Additional Federal Home Loan Bank stock was purchased due to an increase in the average balances of Federal Home Loan Bank advances which were needed to fund loan originations.

Interest income on securities of \$627 thousand for the year ended December 31, 2006 remained relatively consistent with the prior year increasing only \$4 thousand. The average yield on the securities portfolio was 4.38% for the year ended December 31, 2006 compared to 4.45% for the same period in 2005.

**Interest Expense.** Interest expense increased \$10.2 million or 61.3%, to \$26.9 million for the year ended December 31, 2006. The increase in interest expense resulted from a 115 basis point increase in the Company's

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cost of funds due to an increase in short term interest rates, as well as a \$58.6 million increase in the average balance of deposits from \$463.2 million for the year ended December 31, 2005 to \$521.8 million for the year ended December 31, 2006. Interest expense on deposits increased \$7.5 million or 61.4%, to \$19.6 million for the year ended December 31, 2006 from \$12.1 million for the same period in 2005. Interest expense on Federal Home Loan Bank advances increased approximately \$2.8 million, or 61.1%, to \$7.4 million for the year ended December 31, 2006 from \$4.6 million for the year ended December 31, 2005 due to a \$22.5 million increase in the average balance of Federal Home Loan Bank advances in order to fund loan demand, as well as an increase in the rates paid on advances.

**Net Interest Income.** As a result of the factors mentioned above, net interest income before the provision for loan losses decreased \$379 thousand or 2.0%, to \$18.6 million for the year ended December 31, 2006 from \$18.9 million for the year ended December 31, 2005. Due to the continued flattening and subsequent inversion of the yield curve, the Company's margins have continued to tighten with the net interest spread decreasing 38 basis points to 2.11% and the net interest margin decreasing 32 basis points to 2.44% compared to the prior year. The ratio of interest earning assets to interest bearing liabilities has also decreased 1.9% due to the continued use of interest earning assets to repurchase stock into treasury.

**Provision for Loan Losses.** A net recovery provision of \$24 thousand was recorded for the year ended December 31, 2006 compared to a \$250 thousand provision recorded for the year ended December 31, 2005. The provision decreased by \$274 thousand due to the continued low level of charge-offs, adjustments made for current peer ratios and changes in other economic factors affecting the loan loss analysis. The allowance for loan losses as a percentage of loans outstanding was 0.63% at December 31, 2006. During the year ended December 31, 2006 the Company had net recoveries of approximately \$3 thousand.

Provisions for loan losses are charged to operations at a level required to reflect probable incurred credit losses in the loan portfolio. In evaluating the level of the allowance for loan losses, management considers historical loss experience, the types of loans and the amount of loans in the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral, peer group information, and prevailing economic conditions. Large groups of smaller balance homogeneous loans, such as residential real estate, small commercial real estate, and home equity and consumer loans, are evaluated in the aggregate using historical loss factors and peer group data adjusted for current economic conditions. Large balance and/or more complex loans, such as multi-family and commercial real estate loans, and classified loans, are evaluated individually for impairment.

This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available or as future events change. The Company used the same methodology and generally similar assumptions in assessing the allowance for both periods. The allowance for loan losses as a percentage of loans outstanding was 0.63% at December 31, 2006 and 0.68% at December 31, 2005. The level of the allowance is based on estimates and the ultimate losses may vary from the estimates.

Management assesses the allowance for loan losses quarterly. While management uses available information to recognize losses on loans, future loan loss provisions may be necessary based on changes in economic conditions. In addition, regulatory agencies, as an integral part of their examination process, periodically review the allowance for loan losses and may require the bank to recognize additional provisions based on their judgment of information available to them at the time of their examination. The allowance for loan losses as of December 31, 2006 was maintained at a level that represented management's best estimate of incurred losses in the loan portfolio to the extent they were both probable and reasonably estimable.

**Noninterest Income.** Noninterest income increased \$73 thousand, or 3.4% to \$2.2 million for the year ended December 31, 2006 from \$2.1 million for the year ended December 31, 2005, primarily due to increased customer service fees of \$131 thousand. During the third quarter of 2006, the Company adjusted various service fees to its customers resulting in increased service fee income for the current year. Additionally, BOLI income

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decreased \$47 thousand to \$628 thousand for the year ended December 31, 2006 from \$675 thousand for the year ended December 31, 2005 due to market conditions related to the interest rate environment. Other miscellaneous fluctuations occurred in various other accounts contributing to the overall net increase.

**Noninterest Expense.** Noninterest expense increased \$155 thousand or 1.2%, to \$13.6 million for the year ended December 31, 2006 from \$13.4 million for the year ended December 31, 2005. This increase was primarily the result of a \$266 thousand increase in other general and administrative expenses and a \$131 thousand increase in salaries and employee benefit expenses. Additionally, occupancy and equipment expenses decreased \$163 thousand and advertising expenses decreased \$65 thousand. Other miscellaneous fluctuations occurred in various other accounts contributing to the overall net increase.

Total other general and administrative expenses increased \$266 thousand, or 23.9%, to \$1.4 million for the year ended December 31, 2006 from \$1.1 million for the year ended December 31, 2005 primarily due to increased debit card servicing fees of \$162 thousand and debit card fraud losses of \$81 thousand resulting from international debit card fraud during the second quarter of 2006. The Company does not expect these fees to continue, and has implemented a new debit card fraud monitoring program that has already significantly reduced these costs effective in August, 2006.

Salaries and employee benefits represented 54.9% and 54.6% of total noninterest expense for the year ended December 31, 2006 and December 31, 2005, respectively. Total salaries and employee benefits increased \$131 thousand, or 1.8%, to \$7.4 million for the year ended December 31, 2006 from \$7.3 million for the same period in 2005. Total Stock Option and Incentive Plan ( SOP ) expenses increased \$162 thousand primarily resulting from the adoption of SFAS 123R in 2006. ESOP compensation expense increased \$85 thousand primarily resulting from an increase in the market value of the Company's stock price during the period. Salary expense increased \$58 thousand due to the addition of 4 full time equivalent employees as well as increased salaries in the current year. Salaries and employee benefits expense was partially reduced by a decrease in stock award expense of \$116 thousand due to the application of SFAS 123R. Other miscellaneous fluctuations occurred in various other benefit accounts contributing to the overall net increase.

Total occupancy and equipment expenses decreased \$163 thousand or 8.4% to \$1.8 million for the year ended December 31, 2006 from \$1.9 million for the same period in 2005 primarily due to various building improvements and repairs completed in 2005.

Advertising fees decreased \$65 thousand due primarily to higher costs incurred during 2005 to introduce and market the Green Account product.

**Income Tax Expense.** Income tax expense decreased \$94 thousand to \$2.5 million for the year ended December 31, 2006, from \$2.6 million for the year ended December 31, 2005. The effective tax rate was 34.9% and 35.3% for the years ended December 31, 2006 and 2005, respectively. The decrease in the effective tax rate was attributable to the tax exempt status of income from the BOLI investment purchased during the first quarter of 2005 and tax credits from the affordable housing fund investment made in December 2004.

## **Critical Accounting Policies**

**Allowance for Loan Losses.** The allowance for loan losses is a valuation allowance for probable incurred credit losses, increased by the provision for loan losses and decreased by chargeoffs less recoveries. Management estimates the allowance balance required using past loan loss experience, peer group information, the nature and volume of the portfolio, information about specific borrower situations and estimated collateral values, economic conditions, and other factors. Allocations of the allowance may be made for specific loans, but the entire allowance is available for any loan that, in management's judgment, should be charged off. Loan losses are charged against the allowance when management believes that the uncollectibility of a loan balance is confirmed.

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The Company believes that the allowance for loan losses and related provision expense are particularly susceptible to change in the near term, as a result of changes in the credit quality, which are evidenced by charge-offs and nonperforming loan trends. Changes in economic conditions, the mix and size of the loan portfolio and individual borrower conditions can dramatically impact the level of allowance for loan losses in relatively short periods of time. Management believes that the allowance for loan losses is maintained at a level that represents the best estimate of probable losses in the loan portfolio. While management uses available information to recognize losses on loans, future additions to the allowance for loan losses may be necessary based on changes in economic conditions. In addition, banking regulators, as an integral part of their examination process, periodically review the allowance for loan losses. These regulatory agencies may require the Company to recognize additions to the allowance for loan losses based on their judgments about information available to them at the time of their examination. Management evaluates current information and events regarding a borrower's ability to repay its obligations and considers a loan to be impaired when the ultimate collectibility of amounts due, according to the contractual terms of the loan agreement, is in doubt. If the loan is collateral-dependent, the fair value of the collateral is used to determine the amount of impairment. Impairment losses are included in the allowance for loan losses through a charge to the provision for loan losses. Subsequent recoveries are credited to the allowance for loan losses. Cash receipts for accruing loans are applied to principal and interest under the contractual terms of the loan agreement. Cash receipts for which the accrual of interest has been discontinued are applied first to principal and then to interest income.

## **Liquidity and Commitments**

The Company is required to have enough investments that qualify as liquid assets in order to maintain sufficient liquidity to ensure a safe and sound operation. Liquidity may increase or decrease depending upon the availability of funds and comparative yields on investments in relation to the return on loans. Historically, the Company has maintained liquid assets above levels believed to be adequate to meet the requirements of normal operations, including potential deposit outflows. Cash flow projections are regularly reviewed and updated to assure that adequate liquidity is maintained.

The Company's liquidity, represented by cash and cash equivalents, is a product of its operating, investing and financing activities. The Company's primary sources of funds are deposits, amortization, prepayments and maturities of outstanding loans and mortgage-backed securities, maturities of investment securities and other short-term investments and funds provided from operations. While scheduled payments from the amortization of loans and mortgage-backed securities and maturing investment securities and short-term investments are relatively predictable sources of funds, deposit flows and loan prepayments are greatly influenced by general interest rates, economic conditions and competition. In addition, the Company invests excess funds in short-term interest-earning assets, which provide liquidity to meet lending requirements. The Company also generates cash through borrowings. The Company utilizes Federal Home Loan Bank advances to leverage its capital base and provide funds for its lending and investment activities, and to enhance its interest rate risk management.

Liquidity management is both a daily and long-term function of business management. Excess liquidity is generally invested in short-term investments such as overnight deposits or U.S. Agency securities. On a longer term basis, the Company maintains a strategy of investing in various lending products as described in greater detail under Item 1. Business of Pacific Trust Bank Lending Activities. The Company uses its sources of funds primarily to meet its ongoing commitments, to pay maturing certificates of deposit and savings withdrawals, to fund loan commitments and to maintain its portfolio of mortgage-backed securities and investment securities. At December 31, 2007, the total approved loan commitments outstanding amounted to \$2.5 million. At the same date, unused lines of credit were \$68.3 million and outstanding letters of credit totaled \$746 thousand. There are no investments and mortgage-backed securities scheduled to mature in one year or less at December 31, 2007, however in February 2008 two agency notes totaling \$4.4 million were called at par. Certificates of deposit scheduled to mature in one year or less at December 31, 2007, totaled \$274.4 million. Although the average cost of deposits increased throughout 2007, management's policy is to maintain deposit rates at levels that are competitive with other local financial institutions. Based on the competitive rates and on

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historical experience, management believes that a significant portion of maturing deposits will remain with the Company. In addition, the Company has the ability at December 31, 2007 to borrow an additional \$157.9 million from the Federal Home Loan Bank of San Francisco as a funding source to meet commitments and for liquidity purposes.

**Commitments**

|                                  | Total<br>Amounts<br>Committed | Amount of Commitment Expiration Per Period |  |  |                       |
|----------------------------------|-------------------------------|--|--|--|-----------------------|
|                                  |                               | One<br>Year<br>or Less                     | Over<br>One Year<br>Through<br>Three Years<br>(in thousands) | Over<br>Three Years<br>Through<br>Five Years | Over<br>Five<br>Years |
| Commitments to extend credit     | \$ 2,546                      | \$ 2,546                                   | \$   | \$   | \$                    |
| Standby letters of credit        | 746                           | 26   |  |  | 720                   |
| Federal Home Loan Bank Advances  | 111,700                       | 81,700                                     | 30,000   |  |                       |
| Operating Lease Obligations      | 1,556                         | 364  | 622  | 406  | 164                   |
| Unused lines of credit           | 68,256                        | 3  | 1,689  | 6,702  | 59,862                |
| Maturing Certificates of Deposit | 305,072                       | 274,395                                    | 25,915   | 4,762  |                       |
|                                  | \$ 489,876                    | \$ 359,034                                 | \$ 58,226  | \$ 11,870                                    | \$ 60,746             |

**Capital**

Consistent with its goals to operate a sound and profitable financial organization, Pacific Trust Bank actively seeks to maintain a well capitalized institution in accordance with regulatory standards. Total capital was \$77.9 million at December 31, 2007, or 10.1% of total assets on that date. As of December 31, 2007, Pacific Trust Bank exceeded all capital requirements of the Office of Thrift Supervision. Pacific Trust Bank's regulatory capital ratios at December 31, 2007 were as follows: core capital 10.05%; Tier I risk-based capital, 13.14%; and total risk-based capital, 13.81%. The regulatory capital requirements to be considered well capitalized are 5.0%, 6.0% and 10.0%, respectively.

**Impact of Inflation**

The consolidated financial statements presented herein have been prepared in accordance with accounting principles generally accepted in the United States of America. These principles require the measurement of financial position and operating results in terms of historical dollars, without considering changes in the relative purchasing power of money over time due to inflation.

The Company's primary assets and liabilities are monetary in nature. As a result, interest rates have a more significant impact on our performance than the effects of general levels of inflation. Interest rates, however, do not necessarily move in the same direction or with the same magnitude as the price of goods and services, since such prices are affected by inflation. In a period of rapidly rising interest rates, the liquidity and maturities structures of our assets and liabilities are critical to the maintenance of acceptable performance levels.

The principal effect of inflation, as distinct from levels of interest rates, on earnings is in the area of noninterest expense. Such expense items as employee compensation, employee benefits and occupancy and equipment costs may be subject to increases as a result of inflation. An additional effect of inflation is the possible increase or decrease in the dollar value of the collateral securing loans that we have made. The Company is unable to determine the extent, if any, to which properties securing our loans have appreciated or depreciated in dollar value due to inflation or other economic conditions.

**Recent Accounting Pronouncements**

Please see Note 1 of the Notes to Consolidated Financial Statements set forth at Item 8.



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### Item 7A. Quantitative and Qualitative Disclosures about Market Risk

#### Asset Liability Management

***Our Risk When Interest Rates Change.*** The rates of interest we earn on assets and pay on liabilities generally are established contractually for a period of time. Market interest rates change over time. Accordingly, our results of operations, like those of other financial institutions, are impacted by changes in interest rates and the interest rate sensitivity of our assets and liabilities. The risk associated with changes in interest rates and our ability to adapt to these changes is known as interest rate risk and is our most significant market risk.

***How We Measure Our Risk of Interest Rate Changes.*** As part of our attempt to manage our exposure to changes in interest rates and comply with applicable regulations, we monitor our interest rate risk. In monitoring interest rate risk we continually analyze and manage assets and liabilities based on their payment streams and interest rates, the timing of their maturities, and their sensitivity to actual or potential changes in market interest rates.

In order to manage the potential for adverse effects of material and prolonged increases in interest rates on our results of operations, we adopted asset and liability management policies to better align the maturities and repricing terms of our interest-earning assets and interest-bearing liabilities. These policies are implemented by the asset and liability management committee. The asset and liability management committee is chaired by the treasurer and is comprised of members of our senior management. The asset and liability management committee establishes guidelines for and monitors the volume and mix of assets and funding sources taking into account relative costs and spreads, interest rate sensitivity and liquidity needs. The objectives are to manage assets and funding sources to produce results that are consistent with liquidity, capital adequacy, growth, risk and profitability goals. The asset and liability management committee meets periodically to review, among other things, economic conditions and interest rate outlook, current and projected liquidity needs and capital position, anticipated changes in the volume and mix of assets and liabilities and interest rate risk exposure limits versus current projections pursuant to net present value of portfolio equity analysis. At each meeting, the asset and liability management committee recommends appropriate strategy changes based on this review. The treasurer or his designee is responsible for reviewing and reporting on the effects of the policy implementations and strategies to the board of directors on a monthly basis.

In order to manage our assets and liabilities and achieve the desired liquidity, credit quality, interest rate risk, profitability and capital targets, we have focused our strategies on:

originating and purchasing adjustable-rate mortgage loans,

originating shorter-term consumer loans,

managing our deposits to establish stable deposit relationships,

using FHLB advances to align maturities and repricing terms, and

attempting to limit the percentage of fixed-rate loans in our portfolio.

At times, depending on the level of general interest rates, the relationship between long- and short-term interest rates, market conditions and competitive factors, the asset and liability management committee may determine to increase the Company's interest rate risk position somewhat in order to maintain its net interest margin.

As part of its procedures, the asset and liability management committee regularly reviews interest rate risk by forecasting the impact of alternative interest rate environments on net interest income and market value of portfolio equity, which is defined as the net present value of an institution's existing assets, liabilities and off-balance sheet instruments, and evaluating such impacts against the maximum potential changes in net interest income and market value of portfolio equity that are authorized by the board of directors of the Company.



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The Office of Thrift Supervision provides Pacific Trust Bank with the information presented in the following tables. They present the projected change in Pacific Trust Bank's net portfolio value at December 31, 2007 and December 31, 2006, that would occur upon an immediate change in interest rates based on Office of Thrift Supervision assumptions, but without giving effect to any steps that management might take to counteract that change.

| Change in                | December 31, 2007   |           |          | Net Portfolio Value  |         |
|--------------------------|---------------------|-----------|----------|----------------------|---------|
| Interest Rates in        | Net Portfolio Value |           |          | as % of PV of Assets |         |
| Basis Points ( bp )      |                     |           |          |                      |         |
| (Rate Shock in Rates)(1) | \$ Amount           | \$ Change | % Change | NPV Ratio            | Change  |
| +300 bp                  | 81,429              | (16,244)  | (17)%    | 10.52%               | (175)bp |
| +200 bp                  | 88,135              | (9,538)   | (10)%    | 11.26%               | (101)bp |
| +100 bp                  | 94,464              | (3,209)   | (3)%     | 11.94%               | (32)bp  |
| 0 bp                     | 97,673              |           |          | 12.27%               | 0 bp    |
| -100 bp                  | 98,742              | 1,069     | +1%      | 12.35%               | +9 bp   |
| -200 bp                  | 98,391              | 718       | +1%      | 12.28%               | +1 bp   |

| Change in                | December 31, 2006   |           |          | Net Portfolio Value  |         |
|--------------------------|---------------------|-----------|----------|----------------------|---------|
| Interest Rates in        | Net Portfolio Value |           |          | as % of PV of Assets |         |
| Basis Points ( bp )      |                     |           |          |                      |         |
| (Rate Shock in Rates)(1) | \$ Amount           | \$ Change | % Change | NPV Ratio            | Change  |
| +300 bp                  | 75,489              | (26,909)  | (26)%    | 9.44%                | (284)bp |
| +200 bp                  | 86,485              | (15,914)  | (16)%    | 10.65%               | (164)bp |
| +100 bp                  | 95,134              | (7,265)   | (7)%     | 11.55%               | (74)bp  |
| 0 bp                     | 102,399             |           |          | 12.29%               | 0 bp    |
| -100 bp                  | 104,127             | 1,729     | +2%      | 12.43%               | 14 bp   |
| -200 bp                  | 106,446             | 4,047     | +4%      | 12.63%               | 35 bp   |

(1) Assumes an instantaneous uniform change in interest rates at all maturities.

The Office of Thrift Supervision uses certain assumptions in assessing the interest rate risk of savings associations. These assumptions relate to interest rates, loan prepayment rates, deposit decay rates, and the market values of certain assets under differing interest rate scenarios, among others.

As with any method of measuring interest rate risk, certain shortcomings are inherent in the method of analysis presented in the foregoing table. For example, although certain assets and liabilities may have similar maturities or periods to repricing, they may react in different degrees to changes in market interest rates. Also, the interest rates on certain types of assets and liabilities may fluctuate in advance of changes in market interest rates, while interest rates on other types may lag behind changes in market rates. Additionally, certain assets, such as adjustable rate mortgage loans, have features which restrict changes in interest rates on a short-term basis and over the life of the asset. Further, if interest rates change, expected rates of prepayments on loans and early withdrawals from certificates could deviate significantly from those assumed in calculating the table.

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**Item 8. Financial Statements and Supplementary Data**

**FIRST PACTRUST BANCORP, INC.**

**Chula Vista, California**

**CONSOLIDATED FINANCIAL STATEMENTS**

**December 31, 2007, 2006, and 2005**

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**MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING**

The management of First PacTrust Bancorp, Inc. (the Company) is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Exchange Act Rule 13a-15(f). The Company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of the financial statements for external purposes in accordance with accounting principles generally accepted in the United States of America. The Company's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the Company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with accounting principles generally accepted in the United States of America, and that receipts and expenditures of the Company are being made only in accordance with authorizations of management and directors of the Company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the Company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. All internal control systems, no matter how well designed, have inherent limitations, including the possibility of human error and the circumvention of overriding controls. Accordingly, even effective internal control over financial reporting can provide reasonable assurance with respect to financial statement preparation. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that degree of compliance with the policies or procedures may deteriorate.

Management has assessed the effectiveness of the Company's internal control over financial reporting as of December 31, 2007, based on the framework set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control - Integrated Framework. Based on that assessment, management concluded that, as of December 31, 2007, the Company's internal control over financial reporting was effective based on the criteria established in Internal Control - Integrated Framework.

The effectiveness of the Company's internal control over financial reporting as of December 31, 2007, has been audited by Crowe Chizek and Company LLP, an independent registered public accounting firm. As stated in their audit report, they express an unqualified opinion on the effectiveness of the Company's internal control over financial reporting as of December 31, 2007. See Report of Independent Registered Public Accounting Firm.

/s/ Hans R. Ganz  
Hans R. Ganz

/s/ Regan J. Lauer  
Regan J. Lauer

President and Chief Executive Officer

Senior Vice President/Controller

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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

Board of Directors

First PacTrust Bancorp, Inc.

Chula Vista, California

We have audited the accompanying consolidated statements of financial condition of First PacTrust Bancorp, Inc. (the Company) as of December 31, 2007 and 2006, and the related consolidated statements of income, shareholders' equity and cash flows for each of the years in the three-year period ended December 31, 2007. We also have audited the Company's internal control over financial reporting as of December 31, 2007, based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company's management is responsible for these financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management's Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on these financial statements and an opinion on the effectiveness of the Company's internal control over financial reporting based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Company as of December 31, 2007 and 2006, and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 2007 in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2007, based on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

Crowe Chizek and Company LLP

Oak Brook, IL

March 5, 2008



**Table of Contents****FIRST PACTRUST BANCORP, INC.****CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION**

December 31, 2007 and 2006

(Amounts in thousands, except share and per share data)

|   | 2007       | 2006       |
|---|------------|------------|
| <b>ASSETS</b>   |            |            |
| Cash and due from banks   | \$ 6,551   | \$ 6,934   |
| Federal funds sold  | 8,635      | 245        |
| Interest-bearing deposits   | 6,610      | 6,816      |
| Total cash and cash equivalents   | 21,796     | 13,995     |
| Interest-bearing deposits in other financial institutions   | 992        | 992        |
| Securities available-for-sale   | 4,367      | 13,989     |
| Federal Home Loan Bank stock, at cost   | 6,842      | 9,794      |
| Loans, net of allowance of \$6,240 in 2007 and \$4,670 in 2006  | 710,095    | 740,044    |
| Accrued interest receivable   | 3,853      | 3,958      |
| Premises and equipment, net   | 4,755      | 4,910      |
| Bank owned life insurance   | 17,042     | 16,349     |
| Other assets  | 4,978      | 4,312      |
| Total assets  | \$ 774,720 | \$ 808,343 |
| <b>LIABILITIES AND SHAREHOLDERS EQUITY</b>  |            |            |
| Deposits:   |            |            |
| Non-interest-bearing  | \$ 17,873  | \$ 14,362  |
| Interest-bearing checking   | 41,115     | 52,917     |
| Money market accounts   | 129,466    | 169,708    |
| Savings accounts  | 80,625     | 43,440     |
| Certificates of deposit   | 305,072    | 290,116    |
| Total deposits  | 574,151    | 570,543    |
| Advances from Federal Home Loan Bank  | 111,700    | 151,200    |
| Accrued expenses and other liabilities  | 4,794      | 4,859      |
| Total liabilities   | 690,645    | 726,602    |
| Commitments and contingent liabilities (Note 10)  |            |            |
| Shareholders' equity:   |            |            |
| Preferred stock, \$.01 par value per share, 5,000,000 shares authorized, no shares issued and outstanding |            |            |
| Common stock, \$.01 par value; 20,000,000 shares authorized; 5,445,000 shares issued                      | 54         | 54         |
| Additional paid-in capital  | 67,537     | 65,940     |
| Retained earnings   | 42,192     | 41,993     |
| Treasury stock, at cost (2007 1,046,262 shares, 2006 1,039,246 shares)                                    | (23,685)   | (23,515)   |
| Unearned employee stock ownership plan (2007 169,280 shares, 2006 211,600 shares)                         | (2,031)    | (2,539)    |
| Accumulated other comprehensive income/(loss)   | 8          | (192)      |
| Total shareholders' equity  | 84,075     | 81,741     |
| Total liabilities and shareholders' equity  | \$ 774,720 | \$ 808,343 |



See accompanying notes to consolidated financial statements.

**Table of Contents****FIRST PACTRUST BANCORP, INC.****CONSOLIDATED STATEMENTS OF INCOME**

Years ended December 31, 2007, 2006, and 2005

(Amounts in thousands, except share and per share data)

|  | 2007            | 2006            | 2005            |
|--|-----------------|-----------------|-----------------|
| Interest and dividend income                               |                 |                 |                 |
| Loans, including fees                                      | \$ 44,632       | \$ 44,202       | \$ 34,510       |
| Securities   | 567             | 627             | 623             |
| Dividends and other interest-earning assets                | 512             | 685             | 518             |
| <b>Total interest and dividend income</b>                  | <b>45,711</b>   | <b>45,514</b>   | <b>35,651</b>   |
| Interest expense   |                 |                 |                 |
| Savings  | 1,353           | 854             | 998             |
| Checking   | 768             | 961             | 959             |
| Money market   | 7,280           | 6,744           | 2,569           |
| Certificates of deposit                                    | 14,461          | 11,024          | 7,606           |
| Federal Home Loan Bank advances                            | 4,985           | 7,362           | 4,571           |
| <b>Total interest expense</b>                              | <b>28,847</b>   | <b>26,945</b>   | <b>16,703</b>   |
| <b>Net interest income</b>                                 | <b>16,864</b>   | <b>18,569</b>   | <b>18,948</b>   |
| Provision for loan losses                                  | 1,588           | (24)            | 250             |
| <b>Net interest income after provision for loan losses</b> | <b>15,276</b>   | <b>18,593</b>   | <b>18,698</b>   |
| Noninterest income   |                 |                 |                 |
| Customer service fees                                      | 1,573           | 1,393           | 1,266           |
| Mortgage loan prepayment penalties                         | 90              | 176             | 160             |
| Income from bank owned life insurance                      | 711             | 628             | 675             |
| Net gain on sales of securities available-for-sale         |                 |                 | 18              |
| Other  | 17              | 20              | 25              |
| <b>Total noninterest income</b>                            | <b>2,391</b>    | <b>2,217</b>    | <b>2,144</b>    |
| Noninterest expense  |                 |                 |                 |
| Salaries and employee benefits                             | 7,271           | 7,449           | 7,318           |
| Occupancy and equipment                                    | 1,840           | 1,770           | 1,933           |
| Advertising  | 353             | 364             | 429             |
| Professional fees  | 531             | 412             | 450             |
| Stationery paper, supplies, and postage                    | 450             | 437             | 422             |
| Data processing  | 1,025           | 853             | 865             |
| ATM costs  | 476             | 505             | 493             |
| Operating loss on equity investment                        | 512             | 395             | 386             |
| Other general and administrative                           | 1,624           | 1,380           | 1,114           |
| <b>Total noninterest expense</b>                           | <b>14,082</b>   | <b>13,565</b>   | <b>13,410</b>   |
| <b>Income before income taxes</b>                          | <b>3,585</b>    | <b>7,245</b>    | <b>7,432</b>    |
| Income tax expense   | 624             | 2,531           | 2,625           |
| <b>Net income</b>  | <b>\$ 2,961</b> | <b>\$ 4,714</b> | <b>\$ 4,807</b> |

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|                            |        |         |         |
|----------------------------|--------|---------|---------|
| Basic earnings per share   | \$ .71 | \$ 1.15 | \$ 1.16 |
| Diluted earnings per share | \$ .70 | \$ 1.12 | \$ 1.13 |

See accompanying notes to consolidated financial statements.

**Table of Contents****FIRST PACTRUST BANCORP, INC.****CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY**

Years ended December 31, 2007, 2006, and 2005

(Amounts in thousands, except share and per share data)

|  | Common<br>Stock | Additional<br>Paid-in<br>Capital | Retained<br>Earnings | Treasury<br>Stock | Unearned<br>ESOP | Unearned<br>Stock<br>Awards | Accumulated<br>Other<br>Comprehensive<br>Income<br>(Loss) | Total        |
|--|-----------------|----------------------------------|----------------------|-------------------|------------------|-----------------------------|---|--------------|
| Balance at January 1, 2005   | \$ 54           | \$ 65,281                        | \$ 37,385            | \$ (17,180)       | \$ (3,555)       | \$ (2,594)                  | \$  | \$ 79,391    |
| Comprehensive income:  |                 |                                  |                      |                   |                  |                             |   |              |
| Net income   |                 |                                  | 4,807                |                   |                  |                             |   | 4,807        |
| Change in net unrealized gain (losses) on securities available-for-sale, net of reclassification and tax effects |                 |                                  |                      |                   |                  |                             | (168)   | (168)        |
| <b>Total comprehensive income</b>  |                 |                                  |                      |                   |                  |                             |   | <b>4,639</b> |
| ESOP forfeitures used to reduce ESOP contribution  |                 | 103                              |                      |                   |                  |                             |   | 103          |
| Options exercised  |                 |                                  |                      | 88                |                  |                             |   | 88           |
| Stock awards earned  |                 |                                  |                      |                   |                  | 728                         |   | 728          |
| Purchase of 239,238 shares of treasury stock   |                 |                                  |                      | (6,201)           |                  |                             |   | (6,201)      |
| Employee stock ownership plan shares earned  |                 | 622                              |                      |                   | 508              |                             |   | 1,130        |
| Tax benefits of RRP shares vesting   |                 | 121                              |                      |                   |                  |                             |   | 121          |
| Dividends declared (\$.53 per share)   |                 |                                  | (2,230)              |                   |                  |                             |   | (2,230)      |
| Balance at December 31, 2005   | 54              | 66,127                           | 39,962               | (23,293)          | (3,047)          | (1,866)                     | (168)   | 77,769       |
| Comprehensive income:  |                 |                                  |                      |                   |                  |                             |   |              |
| Net income   |                 |                                  | 4,714                |                   |                  |                             |   | 4,714        |
| Change in net unrealized gain (losses) on securities available-for-sale, net of reclassification and tax effects |                 |                                  |                      |                   |                  |                             | (24)  | (24)         |
| <b>Total comprehensive income</b>  |                 |                                  |                      |                   |                  |                             |   | <b>4,690</b> |
| ESOP forfeitures used to reduce ESOP contribution  |                 | 26                               |                      |                   |                  |                             |   | 26           |
| Options exercised  |                 | 8                                |                      | 357               |                  |                             |   | 365          |
| Stock option compensation expense  |                 | 162                              |                      |                   |                  |                             |   | 162          |
| Stock awards earned  |                 | 612                              |                      |                   |                  |                             |   | 612          |
| Issuance of stock awards   |                 | (23)                             |                      | 23                |                  |                             |   |              |
| Purchase of 20,708 shares of treasury stock  |                 |                                  |                      | (602)             |                  |                             |   | (602)        |
| Employee stock ownership plan shares earned  |                 | 701                              |                      |                   | 508              |                             |   | 1,209        |
| Tax benefits of RRP shares vesting   |                 | 193                              |                      |                   |                  |                             |   | 193          |
| Dividends declared (\$.63 per share)   |                 |                                  | (2,683)              |                   |                  |                             |   | (2,683)      |
| Transferred to APIC (stock awards)   |                 | (1,866)                          |                      |                   |                  | 1,866                       |   |              |
| Balance at December 31, 2006   | 54              | 65,940                           | 41,993               | (23,515)          | (2,539)          |                             | (192)   | 81,741       |
| Adjustment to adopt FIN 48   |                 |                                  | 328                  |                   |                  |                             |   | 328          |
| Comprehensive income:  |                 |                                  |                      |                   |                  |                             |   |              |
| Net income   |                 |                                  | 2,961                |                   |                  |                             |   | 2,961        |
| Change in net unrealized gain (losses) on securities available-for-sale, net of reclassification and tax effects |                 |                                  |                      |                   |                  |                             | 200   | 200          |
| <b>Total comprehensive income</b>  |                 |                                  |                      |                   |                  |                             |   | <b>3,161</b> |
| ESOP forfeitures used to reduce ESOP contribution  |                 | (41)                             |                      |                   |                  |                             |   | (41)         |

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|   |       |           |             |
|---|-------|-----------|-------------|
| Options exercised                           | (19)  | 233       | 214         |
| Stock option compensation expense           | 316   |           | 316         |
| Stock awards earned                         | 686   |           | 686         |
| Purchase of 17,320 shares of treasury stock |       | (403)     | (403)       |
| Employee stock ownership plan shares earned | 536   | 508       | 1,044       |
| Tax benefits of RRP shares vesting          | 119   |           | 119         |
| Dividends declared (\$.74 per share)        |       | (3,090)   | (3,090)     |
| Balance at December 31, 2007                | \$ 54 | \$ 67,537 | \$ 42,192   |
|   |       |           | \$ (23,685) |
|   |       |           | \$ (2,031)  |
|   |       |           | \$ 8        |
|   |       |           | \$ 84,075   |

See accompanying notes to consolidated financial statements.

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**FIRST PACTRUST BANCORP, INC.**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**

Years ended December 31, 2007, 2006, and 2005

(Amounts in thousands)

|  | 2007     | 2006     | 2005     |
|--|----------|----------|----------|
| <b>Cash flows from operating activities</b>  |          |          |          |
| Net income   | \$ 2,961 | \$ 4,714 | \$ 4,807 |
| Adjustments to reconcile net income to net cash provided by operating activities   |          |          |          |
| Provision for loan losses  | 1,588    | (24)     | 250      |
| Net accretion of securities  | (18)     | (20)     | (20)     |
| Depreciation and amortization  | 452      | 461      | 508      |
| Employee stock ownership plan compensation expense                                 | 1,044    | 1,209    | 1,130    |
| Stock option compensation expense  | 316      | 162      |          |
| Stock award compensation expense   | 686      | 612      | 728      |
| Realized gain on sales of securities available-for-sale, net                       |          |          | (18)     |
| Bank owned life insurance income   | (711)    | (628)    | (675)    |
| Operating loss on equity investment  | 512      | 395      | 386      |
| Loss on sale of property and equipment   |          | 25       |          |
| Deferred income tax (benefit)/expense  | (1,181)  | 166      | 569      |
| Interest capitalized on negative amortizing loans                                  | (1,589)  | (1,733)  | (519)    |
| Federal Home Loan Bank stock dividends   | (436)    | (462)    | (339)    |
| Net change in:   |          |          |          |
| Deferred loan costs  | (203)    | (272)    | (530)    |
| Accrued interest receivable  | (91)     | (990)    | (713)    |
| Other assets   | 843      | 474      | 83       |
| Accrued interest payable and other liabilities                                     | (636)    | (322)    | 259      |
| Net cash provided by operating activities  | 3,537    | 3,767    | 5,906    |
| <b>Cash flows from investing activities</b>  |          |          |          |
| Proceeds from sales of securities available-for-sale                               | 10,176   |          | 71       |
| Proceeds from maturities and principal repayments of securities available-for-sale | 1        | 3        | 3        |
| Purchases of securities available-for-sale   |          |          | (4,316)  |
| Funding of equity investment   | (166)    | (1,104)  | (1,474)  |
| Loan originations and principal collections, net                                   | 31,211   | (49,518) | (33,491) |
| Purchase of loans  | (1,058)  |          | (25,483) |
| Additions to premises and equipment  | (300)    | (216)    | (409)    |
| Proceeds from sale of equipment  | 3        |          |          |
| Net change in other interest-bearing deposits                                      |          | 515      | 983      |
| Purchase of bank owned life insurance  |          |          | (15,000) |
| Redemption of Federal Home Loan Bank stock   | 3,388    | 266      | 216      |
| Purchase of Federal Home Loan Bank stock   |          | (1,075)  | (616)    |
| Net cash provided by (used in) investing activities                                | 43,255   | (51,129) | (79,516) |
| <b>Cash flows from financing activities</b>  |          |          |          |
| Net increase in deposits   | 3,608    | 62,377   | 54,575   |
| Net change in Federal Home Loan Bank open line                                     | (40,500) | (3,000)  | 55,700   |
| Repayments of Federal Home Loan Bank advances                                      | (14,000) | (50,000) | (27,000) |
| Proceeds from Federal Home Loan Bank advances                                      | 15,000   | 40,000   |          |
| ESOP forfeiture to reduce ESOP contribution  | (41)     | 26       | 103      |
| Exercise of stock options  | 214      | 365      | 88       |
| Tax benefits from exercise of stock options  | 37       | 58       | 12       |
| Tax benefit from RRP shares vesting  | 119      | 193      | 121      |
| Purchase of treasury stock   | (403)    | (602)    | (6,201)  |
| Dividends paid on common stock   | (3,025)  | (1,933)  | (2,230)  |
| Net cash provided by (used in) financing activities                                | (38,991) | 47,484   | 75,168   |

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|   |  |                  |                  |
|---|--|------------------|------------------|
| Net change in cash and cash equivalents         | \$ 7,801   | \$ 122           | \$ 1,558         |
| Cash and cash equivalents at beginning of year  | 13,995   | 13,873           | 12,315           |
| <b>Cash and cash equivalents at end of year</b> | <b>\$ 21,796</b>   | <b>\$ 13,995</b> | <b>\$ 13,873</b> |
| Supplemental cash flow information              |  |                  |                  |
| Interest paid on deposits and borrowed funds    | \$ 29,093  | \$ 26,663        | \$ 16,366        |
| Income taxes paid                               | 1,280  | 1,750            | 2,434            |
| Supplemental disclosure of noncash activities   |  |                  |                  |
| Adjustment to adopt FIN 48                      | 328  |                  |                  |
|   | See accompanying notes to consolidated financial statements. |                  |                  |

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**FIRST PACTRUST BANCORP, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**December 31, 2007, 2006, and 2005**

**(Amounts in thousands, except share and per share data)**

**NOTE 1 CONVERSION TO STOCK FORM OF OWNERSHIP**

On March 1, 2002, the Board of Directors of Pacific Trust Bank (the Bank) adopted a plan of conversion to convert from a federally chartered mutual savings bank to a federally chartered stock savings bank with the concurrent formation of a holding company. The conversion was accomplished through the sale of all of the Bank's stock to First PacTrust Bancorp, Inc. (the Company) and the sale of the Company's stock to the public on August 22, 2002.

In connection with the conversion, the Company issued 5,290,000 shares of common stock for gross proceeds of \$63.5 million. The Company loaned \$5.1 million to the Bank's employee stock ownership plan (ESOP) to purchase stock in the offering and incurred \$1.7 million of expenses associated with the offering, resulting in net proceeds of \$56.7 million. The aggregate purchase price was determined by an independent appraisal. The Bank issued all of its outstanding capital stock to the Company in exchange for one-half of the net proceeds of the offering.

In accordance with Statement of Financial Accounting Standards No. 141, *Business Combinations*, when accounting for a transfer of assets or exchange of shares between entities under common control, the entity that receives the net assets or the equity interests shall initially recognize the assets and liabilities transferred at their carrying amounts in the accounts of the transferring entity at the date of transfer. Therefore, First PacTrust Bancorp, Inc. recorded the acquisition of the Bank at historical cost.

**NOTE 2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

*Principles of Consolidation:* The accompanying consolidated financial statements include the accounts of the Company and its wholly owned subsidiary, the Bank. All significant intercompany transactions and balances are eliminated in consolidation.

*Nature of Operations:* The only business of the Company is the ownership of the Bank. The Bank is a federally chartered stock savings bank and member of the Federal Home Loan Bank (FHLB) system, which maintains insurance on deposit accounts with the Savings Association Insurance Fund (SAIF) of the Federal Deposit Insurance Corporation. The Bank is engaged in the business of retail banking with operations conducted through its main office and eight branches located in the San Diego and Riverside counties. There are no significant concentrations of loans to any one industry or customer. However, the customers' ability to repay their loans is dependent on the real estate and general economic conditions in the area.

The accounting and reporting policies of the Company are based upon U.S. generally accepted accounting principles and conform to predominant practices within the banking industry. Significant accounting policies followed by the Company are presented below.

*Use of Estimates in the Preparation of Financial Statements:* The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions based on available information. These estimates and assumptions affect the amounts reported in the financial statements and disclosures provided, and actual results could differ. The allowance for loan losses and fair value of financial instruments are particularly subject to change.

*Cash Flows:* Cash and cash equivalents include cash on hand, deposits with other financial institutions under 90 days, and daily federal funds sold. Net cash flows are reported for customer loan and deposit transactions, interest bearing deposits in other financial institutions, and federal funds purchased, including overnight borrowings with the Federal Home Loan Bank.



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**FIRST PACTRUST BANCORP, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**December 31, 2007, 2006, and 2005**

**(Amounts in thousands, except share and per share data)**

*Interest-bearing Deposits in Other Financial Institutions:* Interest-bearing deposits in other financial institutions mature within one year and are carried at cost.

*Securities:* Debt securities are classified as held to maturity when the Company has the positive intent and ability to hold those securities to maturity. Debt securities are classified as available for sale when they might be sold before maturity. Securities available for sale are carried at fair value with unrealized holding gains and losses, net of taxes, reported in other comprehensive income, net of tax.

Interest income includes amortization of purchase premium or discount. Premiums and discounts on securities are amortized on the level-yield method without anticipating prepayments, except for mortgage backed securities where prepayments are anticipated. Gains and losses on sales are recorded on the trade date and determined using the specific identification method.

Declines in the fair value of securities below their cost that are other than temporary are reflected as realized losses. In estimating other-than-temporary losses, management considers: the length of time and extent that fair value has been less than cost, the financial condition and near term prospects of the issuer, and the Company's ability and intent to hold the security for a period sufficient to allow for any anticipated recovery in fair value.

*Federal Home Loan Bank (FHLB) Stock:* The Bank is a member of the FHLB system. Members are required to own a certain amount of stock based on the level of borrowings and other factors, and may invest in additional amounts. FHLB stock is carried at cost, classified as a restricted security, and periodically evaluated for impairment based on ultimate recovery of par value. Both cash and stock dividends are reported as income.

*Affordable Housing Fund:* The Company has a 19% equity investment in an affordable housing fund originally totaling \$4.2 million for purposes of obtaining tax credits and for Community Reinvestment Act purposes. This investment is recorded in other assets on the balance sheet and is accounted for using the equity method of accounting. Under the equity method of accounting, the Company recognizes its ownership share of the profits and losses of the Fund. The Company obtains tax credits from these investments which reduce income tax expense for a period of 10 years. This investment is regularly evaluated for impairment by comparing the carrying value to the remaining tax credits expected to be received. For year ending 2007, 2006 and 2005 the fund had an operating loss of \$512 thousand, \$395 thousand and \$386 thousand respectively. The balance of the investment at December 31, 2007 and December 31, 2006 was \$2.9 million and \$3.4 million, respectively, and is included in other assets.

*Loans:* Loans that management has the intent and ability to hold for the foreseeable future or until maturity or payoff are reported at the principal balance outstanding, net of unearned interest, deferred loan fees and costs, and an allowance for loan losses. Interest income is accrued on the unpaid principal balance and includes amortization of net deferred loan fees and costs over the loan term.

Interest income on mortgage and commercial loans is discontinued at the time the loan is 91 days delinquent./ Consumer loans, other than those secured by real estate, are typically charged off no later than 180 days past due. Past due status is based on the contractual terms of the loan. In all cases, loans are placed on nonaccrual or charged-off at an earlier date if collection of principal or interest is considered doubtful.

All interest accrued but not received for loans placed on nonaccrual is reversed against interest income. Interest received on such loans is accounted for on the cash-basis or cost-recovery method, until qualifying for return to accrual. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

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**FIRST PACTRUST BANCORP, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**December 31, 2007, 2006, and 2005**

**(Amounts in thousands, except share and per share data)**

*Allowance for Loan Losses:* The allowance for loan losses is a valuation allowance for probable incurred credit losses. Loan losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance. Management estimates the allowance balance required using past loan loss experience, peer group information, the nature and volume of the portfolio, information about specific borrower situations and estimated collateral values, economic conditions, and other factors.

The allowance consists of specific and general components. The specific component relates to loans that are individually classified as impaired or loans otherwise classified as substandard or doubtful. The general component covers non-classified loans and is based on historical loss experience adjusted for peer group information and other current factors including changes in underwriting standards, changes in products offered, rate and staffing changes, current economic conditions and experience history. The allowance is evaluated by management on a monthly basis.

A loan is impaired when full payment under the loan terms is not expected. Impairment is evaluated in total for smaller-balance loans of similar nature, such as residential mortgage and consumer loans, and on an individual loan basis for other loans. If a loan is impaired, a portion of the allowance is allocated so that the loan is reported, net, at the present value of estimated future cash flows using the loan's existing rate or at the fair value of collateral if repayment is expected solely from the collateral. Large groups of smaller balance homogeneous loans, such as consumer and residential real estate loans are collectively evaluated for impairment, and accordingly, they are not separately identified for impairment disclosures.

*Premises and Equipment:* Land is carried at cost. Premises and equipment are stated at cost less accumulated depreciation and are depreciated using the straight-line method with an average useful lives ranging from five to forty years.

Building and leasehold improvements are depreciated using the straight-line method over estimated useful lives not to exceed the lease term. Lease terms range up to ten years. Furniture, fixtures, and equipment are depreciated using the straight-line method with useful lives ranging from five to seven years. Maintenance and repairs are charged to expense as incurred, and improvements that extend the useful lives of assets are capitalized.

*Bank Owned Life Insurance:* The Company has purchased life insurance policies on certain key executives. Bank owned life insurance is recorded at its cash surrender value (or the amount that can be realized).

*Long-term Assets:* Premises and equipment and other long-term assets are reviewed for impairment when events indicate their carrying amount may not be recoverable from future undiscounted cash flows. If impaired, the assets are recorded at fair value.

*Loan Commitments and Related Financial Statements:* Financial instruments include off-balance sheet credit instruments, such as commitments to make loans and commercial letters of credit, issued to meet customer financing needs. The face amount for these items represents the exposure to loss, before considering customer collateral or ability to repay. Such financial instruments are recorded when they are funded.

*Stock Based Compensation:* Effective January 1, 2006, the Company adopted Statement of Financial Accounting Standards ( SFAS ) No. 123(R), *Share-based Payment*, using the modified prospective transition method. Accordingly, the Company has recorded stock-based employee compensation cost using the fair value method starting in 2006.

**Table of Contents****FIRST PACTRUST BANCORP, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****December 31, 2007, 2006, and 2005****(Amounts in thousands, except share and per share data)**

Prior to January 1, 2006, employee compensation expense under stock options was reported using the intrinsic value method; therefore, no stock-based compensation cost is reflected in net income for the year ending December 31, 2005, as all options granted had an exercise price equal to or greater than the market price of the underlying common stock at date of grant.

The following table illustrates the effect on net income and earnings per share if expense was measured using the fair value recognition provisions of FASB Statement No. 123, *Accounting for Stock-Based Compensation*, for the year ending December 31, 2005.

|   | <b>2005</b>     |
|---|-----------------|
| Net income as reported  | \$ 4,807        |
| Deduct: Stock-based compensation expense determined under fair value based method, net of tax | 205             |
| <b>Pro forma net income</b>   | <b>\$ 4,602</b> |
| Basic earnings per share as reported  | \$ 1.16         |
| Pro forma basic earnings per share  | 1.11            |
| Diluted earnings per share as reported  | 1.13            |
| Pro forma diluted earnings per share  | 1.08            |

*Income Taxes:* Income tax expense is the total of the current year income tax due or refundable and the change in deferred tax assets and liabilities. Deferred tax assets and liabilities are the expected future tax amounts for the temporary differences between carrying amounts and tax bases of assets and liabilities, computed using enacted tax rates. A valuation allowance, if needed, reduces deferred tax assets to the amount expected to be realized.

*Employee Stock Ownership Plan:* The cost of shares issued to the ESOP but not yet allocated to participants is shown as a reduction of shareholders' equity. Compensation expense is based on the average market price of shares as they are committed to be released to participant accounts. Dividends on allocated ESOP shares reduces retained earnings; dividends on unearned ESOP shares reduce debt and accrued interest. During 2007, 2006 and 2005, 4,558, 5,987 and 9,838 shares were forfeited. Per the provisions of the ESOP plan, forfeited shares were sold out of the plan and used to reduce the Company's contribution resulting in a reduction of compensation expense in 2007, 2006 and 2005 of \$124 thousand, \$140 thousand, and \$165 thousand respectively.

*Earnings Per Common Share:* Basic earnings per common share is net income divided by the weighted average number of common shares outstanding during the period. ESOP shares are considered outstanding for this calculation unless unearned. Diluted earnings per common share includes the dilutive effect of additional potential common shares issuable under stock options and stock awards.

*Comprehensive Income:* Comprehensive income consists of net income and other comprehensive income. Other comprehensive income includes unrealized gains and losses on securities available for sale, net of tax, which are also recognized as a separate component of equity.

*Loss Contingencies:* Loss contingencies, including claims and legal actions arising in the ordinary course of business, are recorded as liabilities when the likelihood of loss is probable and an amount or range of loss can be reasonably estimated. Management does not believe there now are such matters that will have a material effect on the financial statements.

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**FIRST PACTRUST BANCORP, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**December 31, 2007, 2006, and 2005**

**(Amounts in thousands, except share and per share data)**

*Restrictions on Cash:* Cash on hand or on deposit with the Federal Reserve Bank was required to meet regulatory reserve and clearing requirements. These balances do not earn interest.

*Fair Value of Financial Instruments:* Fair values of financial instruments are estimated using relevant market information and other assumptions, as more fully disclosed in a separate note. Fair value estimates involve uncertainties and matters of significant judgment regarding interest rates, credit risk, prepayments, and other factors, especially in the absence of broad markets for particular items. Changes in assumptions or in market conditions could significantly affect the estimates.

*Operating Segments:* While the chief decision-makers monitor the revenue streams of the various products and services, the identifiable segments are not material and operations are managed and financial performance is evaluated on a Company-wide basis. Operating segments are aggregated into one as operating results for all segments are similar. Accordingly, all of the financial service operations are considered by management to be aggregated in one reportable operating segment.

*Dividend Restriction:* Banking regulations require maintaining certain capital levels and may limit the dividends paid by the bank to the holding company or by the holding company to shareholders.

*Reclassifications:* Some items in the prior year financial statements were reclassified to conform to the current presentation.

*Adoption of New Accounting Standards:* The Company adopted FASB Interpretation 48, *Accounting for Uncertainty in Income Taxes* (FIN 48), as of January 1, 2007. A tax position is recognized as a benefit only if it is more likely than not that the tax position would be sustained in a tax examination, with a tax examination being presumed to occur. The amount recognized is the largest amount of tax benefit that is greater than 50% likely of being realized on examination. For tax positions not meeting the more likely than not test, no tax benefit is recorded.

As a result of adoption, the Company recognized an increase to deferred tax assets of \$328 thousand for uncertain tax positions. This amount was accounted for by increasing the beginning balance of retained earnings on the balance sheet. After recording the cumulative effect at the beginning of 2007, the Company had approximately \$109 thousand of total gross unrecognized tax benefits at December 31, 2007. Of this total, \$109 thousand represents the amount of unrecognized tax benefits that, if recognized, would favorably affect the effective income tax rate in future periods.

The Company and its subsidiaries are subject to U.S. federal income tax as well as income tax of multiple state jurisdictions. The Company is no longer subject to examination by U.S. Federal taxing authorities for years before 2004 and for all state income taxes through 2002. The Company does not expect the total amount of unrecognized tax benefits to significantly increase or decrease in the next twelve months.

The Company recognizes interest and/or penalties related to income tax matters in income tax expense. The Company had \$0 accrued for interest and penalties at December 31, 2007.

In September 2006, the FASB Emerging Issues Task Force finalized Issue No. 06-5, *Accounting for Purchases of Life Insurance - Determining the Amount That Could Be Realized in Accordance with FASB Technical Bulletin No. 85-4 (Accounting for Purchases of Life Insurance)*. The Task Force reached a consensus

**Table of Contents****FIRST PACTRUST BANCORP, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****December 31, 2007, 2006, and 2005****(Amounts in thousands, except share and per share data)**

that a policyholder should consider any additional amounts included in the contractual terms of the policy in determining the amount that could be realized under the insurance contract. The Task Force agreed that contractual limitations should be considered when determining the realizable amounts. Those amounts that are recoverable by the policyholder at the discretion of the insurance company should be excluded from the amount that could be realized. The Task Force also agreed that fixed amounts that are recoverable by the policyholder in future periods in excess of one year from the surrender of the policy should be recognized at their present value. The Task Force also reached a consensus that a policyholder should determine the amount that could be realized under the life insurance contract assuming the surrender of an individual life by individual life policy. The Task Force also noted that any amount that is ultimately realized by the policyholder upon the assumed surrender of the final policy shall be included in the amount that could be realized under the insurance contract. The issue was effective for fiscal years beginning after December 15, 2006. The adoption of this standard did not have a material impact on the financial statements.

*New Accounting Pronouncements:* In September 2006, the FASB issued Statement No. 157, *Fair Value Measurements*. This Statement defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. This Statement establishes a fair value hierarchy about the assumptions used to measure fair value and clarifies assumptions about risk and the effect of a restriction on the sale or use of an asset. The standard is effective for fiscal years beginning after November 15, 2007. The impact of adoption was not material.

In February 2007, the FASB issued Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*. This Statement allows companies to record certain financial assets and liabilities at full fair value if they so choose. This statement was issued to mitigate volatility in reporting earnings caused by an accounting model using multiple measurement attributes. The effective date is the beginning of the first fiscal year after November 15, 2007. Early adoption must be made within 120 days of the beginning of the fiscal year of adoption. Early adoption also requires the adoption of the requirements of Statement No. 157, *Fair Value Measurements*. The Company did not elect the fair value option for any financial assets or financial liabilities as of January 1, 2008.

**NOTE 3 SECURITIES**

The fair value of securities available for sale and the related gross unrealized gains and losses recognized in accumulated other comprehensive income (loss) were as follows:

|  | Fair<br>Value | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses |
|--|---------------|------------------------------|-------------------------------|
| 2007                                     |               |                              |                               |
| Agency securities FNMA/FHLB notes        | \$ 4,361      | \$ 14                        | \$                            |
| Collateralized mortgage obligations      |               |                              |                               |
| Federal National Mortgage Association    | 5             |                              |                               |
| Government National Mortgage Association | 1             |                              |                               |
| Total securities available for sale      | \$ 4,367      | 14                           |                               |

**Table of Contents****FIRST PACTRUST BANCORP, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****December 31, 2007, 2006, and 2005****(Amounts in thousands, except share and per share data)**

Two FNMA notes totaling \$10.0 million were sold in November, 2007. The remaining FNMA/FHLB notes were called in February, 2008.

|  | Fair<br>Value | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses |
|--|---------------|------------------------------|-------------------------------|
| 2006                                     |               |                              |                               |
| Agency securities FNMA/FHLB notes        | \$ 13,982     | \$                           | \$ (327)                      |
| Collateralized mortgage obligations      |               |                              |                               |
| Federal National Mortgage Association    | 6             |                              |                               |
| Government National Mortgage Association | 1             |                              |                               |
| Total securities available for sale      | \$ 13,989     | \$                           | \$ (327)                      |

Sales of securities available-for-sale were as follows:

|                                   | 2007      | 2006 | 2005  |
|-----------------------------------|-----------|------|-------|
| Proceeds from sales of securities | \$ 10,176 | \$   | \$ 71 |
| Net realized gains/losses         | \$        | \$   | 18    |

At year end 2007 and 2006, there were no holdings of securities of any one issuer, other than the U.S. Government and its agencies, in an amount greater than 10% of shareholders' equity. The tax provision related to these net realized gains was \$0, \$0, and \$7 thousand, respectively.

There were no securities with unrealized losses at year-end 2007.

Securities with unrealized gains or losses at year-end 2006 which represent all debt securities held by the Company, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, are as follows:

| Description of Securities        | Less than 12<br>Months |                    | 12 Months or More |                    | Total         |                    |
|----------------------------------|------------------------|--------------------|-------------------|--------------------|---------------|--------------------|
|                                  | Fair<br>Value          | Unrealized<br>Loss | Fair<br>Value     | Unrealized<br>Loss | Fair<br>Value | Unrealized<br>Loss |
| Agency securities FNMA/FHLB Note | \$                     | \$                 | \$ 13,982         | \$ (327)           | \$ 13,982     | \$ (327)           |
| Total temporarily impaired       | \$                     | \$                 | \$ 13,982         | \$ (327)           | \$ 13,982     | \$ (327)           |

The Company evaluates securities for other-than-temporary impairment at least on a quarterly basis, and more frequently when economic or market concerns warrant such evaluation. Consideration is given to the length of time and the extent to which the fair value has been less than cost, the financial condition and near-term prospects of the issuer, and the intent and ability of the Company to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value. In analyzing an issuer's financial condition, the Company may consider whether the securities are issued by the federal government or its agencies, whether downgrades by bond rating agencies have occurred,

and the results of reviews of the issuer's financial condition.

**Table of Contents****FIRST PACTRUST BANCORP, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****December 31, 2007, 2006, and 2005****(Amounts in thousands, except share and per share data)**

As of December 31, 2007, the Company had recorded \$14 thousand of unrealized gains on two agency securities. As of December 31, 2006, the Company had recorded \$327 thousand unrealized losses on four agency securities. The unrealized gains and/or losses relate principally to the general change in interest rate levels that has occurred since the securities purchase dates, and such unrecognized losses will continue to vary with general interest rate level fluctuations in the future. As management has the ability to hold these debt securities, classified as available for sale, until their forecasted recovery date which may be maturity, no declines are deemed to be other than temporary.

**NOTE 4 LOANS**

Loans receivable consist of the following:

|   | 2007           | 2006           |
|---|----------------|----------------|
| One-to-four-family                      | \$ 421,064     | \$ 515,891     |
| Commercial real estate and multi-family | 72,839         | 86,202         |
| Construction loans                      | 18,866         | 16,409         |
| Home equity real estate secured loans   | 175,702        | 100,545        |
| Consumer                                | 2,553          | 2,944          |
| Commercial                              | 1,398          | 611            |
| Land                                    | 21,705         | 20,108         |
| <br>Total                               | <br>714,127    | <br>742,710    |
| Allowance for loan losses               | (6,240)        | (4,670)        |
| Net deferred loan costs                 | 2,208          | 2,004          |
| <br>Loans receivable, net               | <br>\$ 710,095 | <br>\$ 740,044 |

At December 31, 2007, the Company has a total of \$294.3 million in interest only mortgage loans and \$48.2 million in loans with potential for negative amortization. At December 31, 2006, the Company had a total of \$343.0 million in interest only mortgage loans and \$77.8 million in potentially negatively amortizing mortgage loans. These loans pose a potentially higher credit risk because of the lack of principal amortization and potential for negative amortization. However, management believes the risk is mitigated through the company's loan terms and underwriting standards, including its policies on loan-to-value ratios. At December 31, 2007 the home equity real estate secured loans includes \$164.0 million of the Company's Green account loans of which \$155.0 million is secured by one-to-four-family loans, \$2.3 million is secured by multi-family properties, \$6.2 million is secured by commercial properties and \$429 thousand is secured by land. At December 31, 2006 the home equity real estate secured loans includes \$84.3 million which was secured by one-to-four-family loans, \$1.3 million is secured by multi-family properties and \$1.7 million was secured by commercial properties.

Activity in the allowance for loan losses is summarized as follows:

|  | 2007     | 2006     | 2005     |
|--|----------|----------|----------|
| Balance at beginning of year               | \$ 4,670 | \$ 4,691 | \$ 4,430 |
| Loans charged off                          | (24)     | (15)     | (25)     |
| Recoveries of loans previously charged off | 6        | 18       | 36       |



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|                           |          |          |          |
|---------------------------|----------|----------|----------|
| Provision for loan losses | 1,588    | (24)     | 250      |
| Balance at end of year    | \$ 6,240 | \$ 4,670 | \$ 4,691 |

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Individually impaired loans were as follows:

|  | 2007          | 2006         |
|--|---------------|--------------|
| Year-end loans with no allocated allowance for loan losses | \$            | \$ 1,952     |
| Year-end loans with allocated allowance for loan losses    | 11,559        |              |
| <b>Total</b>   | <b>11,559</b> | <b>1,952</b> |
| Amount of the allowance for loan losses allocated          | \$ 2,278      | \$           |

|  | 2007     | 2006   | 2005 |
|--|----------|--------|------|
| Average of individually impaired loans during year | \$ 5,942 | \$ 163 | \$   |
| Interest income recognized during impairment       |          |        |      |
| Cash-basis interest income recognized              |          |        |      |

Nonperforming loans were as follows:

|  | 2007      | 2006     |
|--|-----------|----------|
| Loans past due over 90 days still on accrual | \$        | \$       |
| Nonaccrual loans                             | \$ 14,132 | \$ 1,952 |

Nonperforming loans includes both smaller balance homogeneous loans that are collectively evaluated for impairment and individually classified impaired loans.

At December 31, 2007, of the nonaccrual loans of \$14.1 million, five loans totaling \$11.6 million are considered impaired. The balance of 2007 nonaccrual and impaired loans is primarily comprised of one construction loan in foreclosure with a loan balance of \$9.9 million. The amount of allowance allocated for these loans is \$2.3 million. At December 31, 2006, the non-accrual loan of \$2.0 million was considered impaired. The amount of allowance allocated was zero since no loss was expected.

**NOTE 5 PREMISES AND EQUIPMENT**

Premises and equipment are summarized as follows:

|                                    | 2007     | 2006     |
|------------------------------------|----------|----------|
| Land and improvements              | \$ 1,638 | \$ 1,638 |
| Buildings                          | 3,930    | 3,809    |
| Furniture, fixtures, and equipment | 3,115    | 3,191    |
| Leasehold improvements             | 1,033    | 982      |

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|  |          |          |
|--|----------|----------|
| Total  | 9,716    | 9,620    |
| Less accumulated depreciation and amortization | (4,961)  | (4,710)  |
| Premises and equipment, net                    | \$ 4,755 | \$ 4,910 |

Depreciation expense was \$453 thousand, \$461 thousand, and \$508 thousand for 2007, 2006, and 2005.

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Pursuant to the terms of noncancelable lease agreements in effect at December 31, 2007 pertaining to banking premises and equipment, future minimum rent commitments under various operating leases are as follows, before considering renewal options that generally are present.

|              |                 |
|--------------|-----------------|
| 2008         | \$ 364          |
| 2009         | 364             |
| 2010         | 258             |
| 2011         | 242             |
| 2012         | 164             |
| Thereafter   | 164             |
| <b>Total</b> | <b>\$ 1,556</b> |

Total rent expense for the years ended December 31, 2007, 2006, and 2005 amounted to \$369 thousand, \$347 thousand, and \$335 thousand.

**NOTE 6 DEPOSITS**

Certificate of deposit accounts with balances of \$100 thousand or more totaled \$135.7 million and \$136.5 million at December 31, 2007 and 2006, respectively. Brokered certificates of deposit were \$3.8 million and \$21.7 million at December 31, 2007 and 2006, respectively.

The scheduled maturities of time deposits at December 31, 2007 are as follows:

|              |                   |
|--------------|-------------------|
| 2008         | \$ 274,395        |
| 2009         | 16,464            |
| 2010         | 9,451             |
| 2011         | 2,369             |
| 2012         | 2,393             |
| <b>Total</b> | <b>\$ 305,072</b> |

**NOTE 7 FEDERAL HOME LOAN BANK ADVANCES**

At December 31, 2007, the interest rates on the Bank's advances from the FHLB ranged from 2.67% to 5.00% with a weighted average rate of 4.06%. At December 31, 2006, the interest rates on the Bank's advances from the FHLB ranged from 2.24% to 5.40% with a weighted average rate of 4.64%. The contractual maturities by year of the Bank's advances are as follows:

|      |             |             |
|------|-------------|-------------|
|      | <b>2007</b> | <b>2006</b> |
| 2007 | \$          | \$ 14,000   |
| 2008 | 45,000      | 45,000      |

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|                      |            |            |
|----------------------|------------|------------|
| 2009                 | 30,000     | 15,000     |
| Overnight borrowings | 36,700     | 77,200     |
| Total advances       | \$ 111,700 | \$ 151,200 |

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Each advance is payable at its maturity date. Advances paid early are subject to a prepayment penalty. At December 31, 2007 and 2006, the Bank's advances from the FHLB were collateralized by certain real estate loans of an aggregate unpaid principal balance of \$416.1 million and \$531.3 million, and the Bank's investment of capital stock of FHLB of San Francisco of \$6.8 million and \$9.8 million, respectively. Based on this collateral and the Company's holdings of FHLB stock, the Company was eligible to borrow an additional \$157.9 million at December 31, 2007.

**NOTE 8 EMPLOYEE STOCK OWNERSHIP PLAN (ESOP)**

The Bank maintains an ESOP for the benefit of its employees. The Company issued 423,200 shares of common stock to the ESOP in exchange for a ten-year note in the amount of approximately \$5.1 million. The \$5.1 million for the ESOP purchase was borrowed from the Company.

Shares issued to the ESOP are allocated to ESOP participants based on principal repayments made by the ESOP on the loan from the Company. The loan is secured by shares purchased with the loan proceeds and will be repaid by the ESOP with funds from the Company's contributions to the ESOP and earnings on ESOP assets. Principal payments are scheduled to occur over a ten-year period. Dividends on allocated and/or unearned shares first reduce accrued interest and secondly principal.

During 2007, 2006 and 2005, 42,320 shares of stock with an average fair value \$24.49, \$28.48, and \$26.32 per share were committed to be released, resulting in ESOP compensation expense of \$778 thousand, \$970 thousand, and \$886 thousand, respectively for each year. During 2007 and 2006, 4,558 and 5,987 shares were forfeited. Per the terms of the ESOP plan, the forfeited shares were sold out of the plan and the proceeds were used to reduce the Company's contribution resulting in a reduction of compensation expense during 2007 and 2006 of \$124 thousand and \$140 thousand, respectively. Shares held by the ESOP at December 31, 2007 and 2006 are as follows:

Shares held by the ESOP were as follows:

|   | 2007           | 2006           |
|---|----------------|----------------|
| Allocated shares to participants          | 209,273        | 183,191        |
| Unearned shares                           | 169,280        | 211,600        |
| <b>Total ESOP shares</b>                  | <b>378,553</b> | <b>394,791</b> |
| Fair value of unearned shares at year end | \$ 3,083       | \$ 5,863       |

**NOTE 9 INCOME TAXES**

Allocation of federal and state income taxes between current and deferred portions is as follows:

|                       | 2007     | 2006     | 2005     |
|-----------------------|----------|----------|----------|
| Current tax provision |          |          |          |
| Federal               | \$ 1,259 | \$ 1,734 | \$ 1,537 |
| State                 | 636      | 631      | 519      |

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|                                |         |          |          |
|--------------------------------|---------|----------|----------|
|                                | 1,895   | 2,365    | 2,056    |
| Deferred tax (benefit) expense |         |          |          |
| Federal                        | (1,054) | 98       | 442      |
| State                          | (217)   | 68       | 127      |
|                                | (1,271) | 166      | 569      |
|                                | \$ 624  | \$ 2,531 | \$ 2,625 |

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The reasons for the differences between the statutory federal income tax rate and the effective tax rates are summarized as follows:

|   | 2007   | 2006  | 2005  |
|---|--------|-------|-------|
| Statutory federal tax rate              | 34.0%  | 34.0% | 34.0% |
| Increase (decrease) resulting from:     |        |       |       |
| State taxes, net of federal tax benefit | 6.2    | 6.9   | 7.5   |
| California housing fund investment      | (11.9) | (4.1) | (4.4) |
| Bank owned life insurance               | (6.7)  | (2.9) | (3.1) |
| Other, net                              | (4.2)  | 1.0   | 1.3   |
| Effective tax rates                     | 17.4%  | 34.9% | 35.3% |

The components of the net deferred tax asset, included in other assets, are as follows:

|  | 2007     | 2006     |
|--|----------|----------|
| Deferred tax assets                              |          |          |
| Allowance for loan losses                        | \$ 2,517 | \$ 1,555 |
| Unrealized loss on securities available-for-sale |          | 135      |
| RRP Plan   | 136      | 150      |
| Section 475 mark-to-market adjustment            | 6        |          |
| SOP Plan   | 197      | 67       |
| Deferred California tax                          | 179      | 212      |
| Investment in Partnership                        | 81       | 126      |
| Other  | 137      | 91       |
|  | 3,253    | 2,336    |
| Deferred tax liabilities                         |          |          |
| Deferred loan costs                              | (926)    | (932)    |
| FHLB stock dividends                             | (637)    | (710)    |
| Section 475 mark-to-market adjustment            |          | (134)    |
| Unrealized gain on securities available-for-sale | (6)      |          |
| Depreciation                                     | (8)      | (38)     |
| Other  | (256)    | (233)    |
|  | (1,833)  | (2,047)  |
| Net deferred tax asset                           | \$ 1,420 | \$ 289   |

At December 31, 2006 and 2005, the Company has a tax-related contingent liability of \$109 thousand and \$437 thousand related to the bad debt deduction for tax purposes. See Note 1 for further discussion.



**NOTE 10 LOAN COMMITMENTS AND OTHER RELATED ACTIVITIES**

Some financial instruments such as loan commitments, credit lines, letters of credit, and overdraft protection are issued to meet customer financing needs. These are agreements to provide credit or to support the credit of others, as long as conditions established in the contract are met, and usually have expiration dates. Commitments

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may expire without being used. Off-balance-sheet risk of credit loss exists up to the face amount of these instruments, although material losses are not anticipated. The same credit policies are used to make such commitments as are used for loans, including obtaining collateral at exercise of the commitment.

The contractual amount of financial instruments with off-balance-sheet risk was as follows at year end:

|  | Contract Amount<br>December 31, |          |
|--|---------------------------------|----------|
|  | 2007                            | 2006     |
| Financial instruments whose contract amounts represent credit risk |                                 |          |
| Commitments to extend credit                                       | \$ 2,511                        | \$ 2,766 |
| Unused lines of credit   | 68,256                          | 49,551   |
| Construction loans in process                                      | 35                              | 3,592    |
| Standby letters of credit  | 746                             | 73       |

At December 31, 2007 and 2006, there were no fixed rate commitments to extend credit. Commitments to make loans are generally made for periods of 30 days or less.

Financial instruments that potentially subject the Bank to concentrations of credit risk include interest-bearing deposit accounts in other financial institutions, and loans. At December 31, 2007 and 2006 respectively, the Bank had deposit accounts with balances totaling approximately \$3.1 million and \$4.0 million held at Pacific Coast Bankers Bank and Bank of the West.

**NOTE 11 REGULATORY CAPITAL MATTERS**

Banks are subject to regulatory capital requirements administered by federal banking agencies. Capital adequacy guidelines and, prompt corrective action regulations involve quantitative measures of assets, liabilities, and certain off-balance-sheet items calculated under regulatory accounting practices. Capital amounts and classifications are also subject to qualitative judgments by regulators. Failure to meet capital requirements can initiate regulatory action.

Prompt corrective action regulations provide five classifications: well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized, although these terms are not used to represent overall financial condition. If adequately capitalized, regulatory approval is required to accept brokered deposits. If undercapitalized, capital distributions are limited, as is asset growth and expansion, and capital restoration plans are required. At year-end 2007 and 2006, the most recent regulatory notifications categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. There are no conditions or events since that notification that management believes have changed the institution's category.

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Actual and required capital amounts and ratios are presented below at year-end.

|   | Actual    |        | Minimum Capital Requirements |       | Minimum Required to Be Well Capitalized Under Prompt Corrective Action Provisions |        |
|---|-----------|--------|------------------------------|-------|---|--------|
|   | Amount    | Ratio  | Amount                       | Ratio | Amount  | Ratio  |
| <b>December 31, 2007</b>                            |           |        |                              |       |   |        |
| Total capital (to risk - weighted assets)           | \$ 81,826 | 13.81% | \$ 47,415                    | 8.00% | \$ 59,269   | 10.00% |
| Tier 1 capital (to risk- weighted assets)           | 77,875    | 13.14  | 23,708                       | 4.00  | 35,562  | 6.00   |
| Tier 1 (core) capital (to adjusted tangible assets) | 77,875    | 10.05  | 30,985                       | 4.00  | 38,732  | 5.00   |
| <b>December 31, 2006</b>                            |           |        |                              |       |   |        |
| Total capital (to risk- weighted assets)            | \$ 80,245 | 14.00% | \$ 45,852                    | 8.00% | \$ 57,315   | 10.00% |
| Tier 1 capital (to risk- weighted assets)           | 75,576    | 13.19  | 22,926                       | 4.00  | 34,389  | 6.00   |
| Tier 1 (core) capital (to adjusted tangible assets) | 75,576    | 9.35   | 32,338                       | 4.00  | 40,422  | 5.00   |

The Qualified Thrift Lender test requires at least 65% of assets be maintained in housing-related finance and other specified areas. If this test is not met, limits are placed on growth, branching, new investments, FHLB advances and dividends, or the Bank must convert to a commercial bank charter. Management believes that this test is met.

**Dividend Restrictions:** The Company's principal source of funds for dividend payments is dividends received from the Bank. Banking regulations limit the amount of dividends that may be paid without prior approval of regulatory agencies. Under these regulations, the amount of dividends that may be paid in any calendar year is limited to the current year's net profits, combined with the retained net profits of the preceding two years, subject to the capital requirements described above. At December 31, 2007, approximately \$1.4 million was available to pay dividends to the holding company.

**NOTE 12 EMPLOYEE BENEFIT PLANS**

The Bank has a 401(k) plan whereby substantially all employees participate in the plan. Employees may contribute up to 15% of their compensation subject to certain limits based on federal tax laws. The Bank makes matching contributions, to be determined annually by the Board of Directors, on the first 4% of the employee's compensation contributed to the plan. Matching contributions vest to the employee at the end of the calendar year in which the contribution was made. For the years ended December 31, 2007, 2006, and 2005, expense attributable to the plan amounted to \$115 thousand, \$115 thousand, and \$110 thousand.

The Company has adopted a Deferred Compensation Plan under Section 401 of the Internal Revenue Code. The purpose of this plan is to provide specified benefits to a select group of management and highly compensated employees. Participants may elect to defer compensation, which accrues interest quarterly at the prime rate as reflected in *The Wall Street Journal* as of the last business day of the prior quarter. The Company does not make contributions to the Plan.

**NOTE 13 EMPLOYEE STOCK COMPENSATION**

The Company has two share based compensation plans as described below. Total compensation cost that has been charged against income for both plans was \$1.0 million, \$774 thousand, and \$729 thousand for 2007, 2006 and 2005. The total income tax benefit was \$156 thousand, \$251

thousand, and \$133 thousand.

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*RRP Plan:* A Recognition and Retention Plan (RRP) provides for issue of shares to directors, officers, and employees. Compensation expense is recognized over the vesting period of the shares based on the market value at date of grant. Pursuant to its 2003 stock-based incentive plan, total shares issuable under the plan are 211,600. See table below for the history of awarded and forfeited shares. There were no shares awarded during 2007. These shares vest over a five-year period. Compensation expense for restricted stock awards totaled approximately \$686 thousand, \$612 thousand and \$729 thousand for the years ended December 31, 2007, 2006 and 2005, respectively.

A summary of changes in the Company's nonvested shares for the year follows:

|                                       | Shares        | Weighted-Average<br>Grant-Date<br>Fair-Value |
|---------------------------------------|---------------|--|
| <b>Nonvested shares</b>               |               |  |
| Nonvested at January 1, 2007          | 90,080        | \$ 18.27                                     |
| Granted                               |               |  |
| Vested                                | 40,560        | \$ 18.00                                     |
| Forfeited                             |               |  |
| <b>Nonvested at December 31, 2007</b> | <b>49,520</b> | <b>\$ 18.48</b>                              |

As of December 31, 2007, there was \$422 thousand of total unrecognized compensation cost related to 49,520 nonvested shares granted under the Plan. The cost is expected to be recognized over a weighted-average period of less than 1 year. The total fair value of shares vested during the years ended December 31, 2007, 2006 and 2005 was \$993 thousand, \$1.7 million and \$1.0 million.

*SOP Plan:* A Stock Option Plan (SOP) provides for issue of options to directors, officers, and employees. The Company adopted the SOP during 2003 under the terms of which 529,000 shares of the Company's common stock may be awarded. The options become exercisable in equal installments over a five-year period from the date of grant. The options expire ten years from the date of grant.

The fair value of options granted and pro forma effects are computed using option pricing models, using the following weighted-average assumptions as of grant date. The fair value of each option award is estimated on the date of grant using a closed form option valuation (Black-Scholes) model that uses the assumptions noted in the table below. Expected volatilities are based on historical volatilities of the Company's common stock. The Company uses historical data to estimate option exercise and post-vesting termination behavior. The expected term of options granted is based on historical data and represents the period of time that options granted are expected to be outstanding, which takes into account that the options are not transferable. The risk-free interest rate for the expected term of the option is based on the U.S. Treasury yield curve in effect at the time of grant. There were no options granted in 2007.

|   | Sept 12<br>2006 | Jan 25<br>2005 |
|---|-----------------|----------------|
| Date of grant                                 |                 |                |
| Options granted                               | 10,000          | 24,000         |
| Estimated fair value of stock options granted | \$ 4.94         | \$ 4.93        |
| Assumptions used:                             |                 |                |

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|                                 |         |         |
|---------------------------------|---------|---------|
| Risk-free interest rate         | 4.71%   | 3.71%   |
| Expected option life            | 5 years | 5 years |
| Expected stock price volatility | 14.98%  | 18.50%  |
| Dividend yield                  | 2.18%   | 1.87%   |

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A summary of the activity for 2007 in the SOP is as follows:

|                                  | Shares   | Weighted<br>Average<br>Exercise<br>Price | Weighted<br>Average<br>Remaining<br>Contractual<br>Term | Aggregate<br>Intrinsic<br>Value |
|----------------------------------|----------|--|---|---------------------------------|
| Outstanding at Beginning of year | 491,700  | \$ 18.46                                 |   |                                 |
| Granted                          | 0        | 0  |   |                                 |
| Exercised                        | (10,304) | 17.19                                    |   |                                 |
| Forfeited or expired             | (10,000) | 24.39                                    |   |                                 |
| Outstanding at end of year       | 471,396  | \$ 18.36                                 | 5.64  | \$                              |
| Options exercisable at year-end  | 342,686  | \$ 17.98                                 | 5.55  | \$ 78,818                       |

Information related to the stock option plan during each year follows:

|  | 2007  | 2006   | 2005  |
|--|-------|--------|-------|
| Intrinsic value of options exercised       | \$ 89 | \$ 143 | \$ 33 |
| Cash received from option exercises        | 177   | 307    | 76    |
| Tax benefit realized from option exercises | 37    | 58     | 12    |

As of December 31, 2007, there was \$217 thousand of total unrecognized compensation cost related to nonvested stock options granted under the Plan. The cost is expected to be recognized over a weighted-average period of less than one year.

**NOTE 14 EARNINGS PER COMMON SHARE**

The factors used in the earnings per share computation follow.

|  | 2007      | 2006      | 2005      |
|--|-----------|-----------|-----------|
| Basic                                      |           |           |           |
| Net income                                 | \$ 2,961  | \$ 4,714  | \$ 4,807  |
| Weighted average common shares outstanding | 4,170,185 | 4,088,126 | 4,134,151 |
| Basic earnings per share                   | \$ 0.71   | \$ 1.15   | \$ 1.16   |
| Diluted                                    |           |           |           |

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|  |           |           |           |
|--|-----------|-----------|-----------|
| Net income   | \$ 2,961  | \$ 4,714  | \$ 4,807  |
| Weighted average common shares outstanding for basic earnings per common share | 4,170,185 | 4,088,126 | 4,134,151 |
| Add: Dilutive effects of stock options   | 63,752    | 96,488    | 90,590    |
| Add: Dilutive effects of stock awards  | 6,178     | 17,607    | 22,595    |
| Average shares and dilutive potential common shares                            | 4,240,115 | 4,202,221 | 4,247,336 |
| Diluted earnings per common share  | \$ 0.70   | \$ 1.12   | \$ 1.13   |

Stock options for 24,000 and 10,000 shares of common stock were not considered in computing diluted earnings per common share for 2007 and 2006 because they were antidilutive.



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The Company has granted loans to certain officers and directors and their related interests.

Activity in the loan accounts of officers and directors and their related interests follows for the year ended December 31, 2007:

|                              |        |
|------------------------------|--------|
| Balance at beginning of year | \$ 522 |
| Loans originated             | 113    |
| Principal repayments         | (133)  |
| Balance at end of year       | \$ 502 |

Deposits from principal officers, directors, and their related interests at year-end 2007 and 2006 were \$3.9 million and \$2.6 million, respectively.

**NOTE 16 FAIR VALUES OF FINANCIAL INSTRUMENTS**

Carrying amount and estimated fair value of financial instruments consist of the following:

|   | December 31, 2007  |                            | December 31, 2006  |                            |
|---|--------------------|----------------------------|--------------------|----------------------------|
|   | Carrying<br>Amount | Estimated<br>Fair<br>Value | Carrying<br>Amount | Estimated<br>Fair<br>Value |
| Financial assets  |                    |                            |                    |                            |
| Cash and cash equivalents                                 | \$ 21,796          | \$ 21,796                  | \$ 13,995          | \$ 13,995                  |
| Interest-bearing deposits in other financial institutions | 992                | 992                        | 992                | 992                        |
| Securities available- for- sale                           | 4,367              | 4,367                      | 13,989             | 13,989                     |
| FHLB stock  | 6,842              | 6,842                      | 9,794              | 9,794                      |
| Loans, net  | 710,095            | 714,313                    | 740,044            | 739,918                    |
| Accrued interest receivable                               | 3,853              | 3,853                      | 3,958              | 3,958                      |
| Financial liabilities                                     |                    |                            |                    |                            |
| Deposits  | \$ 574,151         | \$ 574,786                 | \$ 570,543         | \$ 570,188                 |
| Federal Home Loan Bank Advances                           | 111,700            | 111,932                    | 151,200            | 150,313                    |
| Accrued interest payable                                  | 668                | 668                        | 914                | 914                        |

The methods and assumptions used to estimate fair value are described as follows:

Carrying amount is the estimated fair value for cash and cash equivalents, interest bearing deposits in other financial institutions, FHLB stock, accrued interest receivable and payable, demand deposits, short-term debt, and variable rate loans or deposits that reprice frequently and fully. Security fair values are based on market prices or dealer quotes and, if no such information is available, on the rate and term of the security and information about the issuer. For fixed rate loans and deposits and for variable rate loans or deposits with infrequent repricing or repricing limits, fair value is based on discounted cash flows using current market rates applied to the estimated life and credit risk. The fair value of advances from the FHLB is based on current rates for similar financing. The fair value of off-balance-sheet items is based on the current fees or the cost

that would be charged to enter into or terminate such arrangements. The fair value of off-balance-sheet financial instruments is immaterial.

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**NOTE 17 OTHER COMPREHENSIVE INCOME (LOSS)**

Other comprehensive income components and related taxes were as follows:

|  | 2007   | 2006    | 2005     |
|--|--------|---------|----------|
| Unrealized holding gains/(losses) on securities available for sale   | \$ 341 | \$ (40) | \$ (269) |
| Reclassification adjustments for gains/(losses) recognized in income | ( )    | ( )     | (18)     |
| Net unrealized gains (losses)  | 341    | (40)    | (287)    |
| Tax effect   | (141)  | 16      | 119      |
| Other comprehensive income (loss)                                    | \$ 200 | \$ (24) | \$ (168) |

**NOTE 18 QUARTERLY RESULTS OF OPERATIONS (UNAUDITED)**

|                            | Three Months Ended |           |              |             |
|----------------------------|--------------------|-----------|--------------|-------------|
|                            | March 31           | June 30   | September 30 | December 31 |
| <b>2007</b>                |                    |           |              |             |
| Interest income            | \$ 11,938          | \$ 11,297 | \$ 11,262    | \$ 11,214   |
| Interest expense           | 7,449              | 7,151     | 7,303        | 6,944       |
| Net interest income        | 4,489              | 4,146     | 3,959        | 4,270       |
| Provision for loan losses  | (16)               | (74)      | 804          | 874         |
| Noninterest income         | 580                | 629       | 593          | 589         |
| Noninterest expense        | 3,498              | 3,676     | 3,620        | 3,288       |
| Income before income taxes | 1,587              | 1,173     | 128          | 697         |
| Income tax expense         | 549                | 373       | (155)        | (143)       |
| Net income                 | \$ 1,038           | \$ 800    | \$ 283       | \$ 840      |
| Basic Earnings per share   | \$ .25             | \$ .19    | \$ .07       | \$ .20      |
| Diluted Earnings per share | \$ .25             | \$ .19    | \$ .07       | \$ .20      |
| <b>2006</b>                |                    |           |              |             |
| Interest income            | \$ 10,309          | \$ 11,290 | \$ 12,012    | \$ 11,903   |
| Interest expense           | 5,560              | 6,505     | 7,367        | 7,513       |
| Net interest income        | 4,749              | 4,785     | 4,645        | 4,390       |

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|                            |          |          |          |          |
|----------------------------|----------|----------|----------|----------|
| Provision for loan losses  | 71       | 112      | (83)     | (124)    |
| Noninterest income         | 514      | 561      | 559      | 583      |
| Noninterest expense        | 3,441    | 3,523    | 3,392    | 3,209    |
| Income before income taxes | 1,751    | 1,711    | 1,895    | 1,888    |
| Income tax expense         | 639      | 589      | 640      | 663      |
| Net income                 | \$ 1,112 | \$ 1,122 | \$ 1,255 | \$ 1,225 |
| Basic Earnings per share   | \$ .27   | \$ .28   | \$ .31   | \$ .30   |
| Diluted Earnings per share | \$ .27   | \$ .27   | \$ .30   | \$ .29   |

**Table of Contents****FIRST PACTRUST BANCORP, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****December 31, 2007, 2006, and 2005****(Amounts in thousands, except share and per share data)****NOTE 19 PARENT COMPANY CONSOLIDATED FINANCIAL STATEMENTS****CONDENSED BALANCE SHEETS****December 31, 2007 and 2006**

|  | <b>2007</b> | <b>2006</b> |
|--|-------------|-------------|
| <b>ASSETS</b>                                |             |             |
| Cash and cash equivalents                    | \$ 4,916    | \$ 4,490    |
| ESOP loan                                    | 2,031       | 2,539       |
| Investment in bank subsidiary                | 77,883      | 75,383      |
| Accrued interest receivable and other assets | 81          | 90          |
| <br>   |             |             |
| Total assets                                 | \$ 84,911   | \$ 82,502   |
| <b>LIABILITIES AND SHAREHOLDERS EQUITY</b>   |             |             |
| Accrued expenses and other liabilities       | \$ 836      | \$ 761      |
| Shareholders' equity                         | 84,075      | 81,741      |
| <br>   |             |             |
| Total liabilities and shareholders' equity   | \$ 84,911   | \$ 82,502   |

**CONDENSED STATEMENTS OF INCOME****For the years ended December 31, 2007, 2006 and 2005**

|  | <b>2007</b> | <b>2006</b> | <b>2005</b> |
|--|-------------|-------------|-------------|
| <b>Income</b>  |             |             |             |
| Dividends from subsidiary  | \$ 3,300    | \$ 3,000    | \$ 5,000    |
| ESOP loan  | 140         | 167         | 195         |
| Deposits in other financial institutions   | 164         | 93          | 112         |
| Other income   |             |             | 18          |
| <br>   |             |             |             |
| Total income   | 3,604       | 3,260       | 5,325       |
| <b>Other Expenses</b>  |             |             |             |
| Other operating expense  | 311         | 222         | 252         |
| <br>   |             |             |             |
| Income before income taxes and equity in undistributed earnings of bank subsidiary | 3,293       | 3,038       | 5,073       |
| Income taxes   | 32          | 16          | 28          |
| <br>   |             |             |             |
| Income before equity in undistributed earnings of bank subsidiary                  | 3,261       | 3,022       | 5,045       |

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|   |          |          |          |
|---|----------|----------|----------|
| Equity in undistributed earnings of bank subsidiary | (300)    | 1,692    | (238)    |
| Net income  | \$ 2,961 | \$ 4,714 | \$ 4,807 |

**Table of Contents****FIRST PACTRUST BANCORP, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****December 31, 2007, 2006, and 2005****(Amounts in thousands, except share and per share data)****CONDENSED STATEMENT OF CASH FLOWS****For the year ended December 31, 2007, 2006 and 2005**

|   | 2007     | 2006     | 2005     |
|---|----------|----------|----------|
| Cash flows from operating activities  |          |          |          |
| Net income  | \$ 2,961 | \$ 4,714 | \$ 4,807 |
| Adjustments to reconcile net income to net cash provided by operating activities: |          |          |          |
| Equity in undistributed subsidiary income   | 300      | (1,692)  | 238      |
| Realized gain on sales of securities available-for-sale, net                      |          |          | (18)     |
| Change in other assets and liabilities  | 232      | 359      | 63       |
| Net cash from operating activities  | 3,493    | 3,381    | 5,090    |
| Cash flows from investing activities  |          |          |          |
| Proceeds from sales of securities available-for-sale                              |          |          | 71       |
| Decrease in other interest-bearing deposits                                       |          | 515      | (9)      |
| Net cash from investing activities  |          | 515      | 62       |
| Cash flows from financing activities  |          |          |          |
| Capital contribution to the subsidiary  | (147)    | (91)     | (157)    |
| ESOP loan payments  | 508      | 508      | 508      |
| Purchase of treasury stock  | (403)    | (602)    | (6,201)  |
| Dividends paid  | (3,025)  | (1,933)  | (2,230)  |
| Net cash from financing activities  | (3,067)  | (2,118)  | (8,080)  |
| Net change in cash and cash equivalents   | 426      | 1,778    | (2,928)  |
| Beginning cash and cash equivalents   | 4,490    | 2,712    | 5,640    |
| Ending cash and cash equivalents  | \$ 4,916 | \$ 4,490 | \$ 2,712 |

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### **Item 9. Changes in and Disagreements With Accountants on Accounting and Financial Disclosure**

No disclosure is required under this Item.

### **Item 9A. Controls and Procedures**

An evaluation of our disclosure controls and procedures (as defined in Section 13(a)-14(c) of the Securities Exchange Act of 1934 (the Exchange Act )) as of December 31, 2007, was carried out under the supervision and with the participation of the our Chief Executive Officer, Principal Financial Officer and several other members of our senior management within the 90-day period preceding the filing date of this annual report. Our Chief Executive Officer and Principal Financial Officer concluded that, as of December 31, 2007, our disclosure controls and procedures were effective in ensuring that the information required to be disclosed by us in the reports we file or submit under the Exchange Act is (i) accumulated and communicated to our management (including our Chief Executive Officer and Principal Financial Officer) in a timely manner, and (ii) recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms.

There were no changes in our internal controls over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act) that occurred during the quarter ended December 31, 2007, that have materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

We do not expect that our disclosure controls and procedures will prevent all error and all fraud. A control procedure, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control procedure are met. Because of the inherent limitations in all control procedures, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the Company have been detected. These inherent limitations include the realities that judgment in decision-making can be faulty, and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the control. The design of any control procedure also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions; over time, controls may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate. Because of the inherent limitations in a cost-effective control procedure, misstatements due to error or fraud may occur and not be detected.

### **Item 9B. Other Information**

None.



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**PART III**

**Item 10. Directors and Executive Officers of the Registrant**

*Directors and Executive Officers.* The information concerning directors of the Company required by this item is incorporated herein by reference from the Company's definitive proxy statement for its 2008 Annual Meeting of Stockholders, a copy of which will be filed with the Securities and Exchange Commission not later than 120 days after the end of the Company's fiscal year. Information concerning the executive officers of the Company who are not directors is incorporated herein by reference from Part I of this Form 10-K under the caption "Executive Officers of the Registrant Who Are Not Directors."

*Audit Committee Financial Expert.* Information concerning the audit committee of the Company's Board of Directors, including information regarding the audit committee financial experts serving on the audit committee, is incorporated herein by reference from the definitive proxy statement for the Annual Meeting of Stockholders to be held in April 2008, except for information contained under the heading "Report of the Audit Committee," a copy of which will be filed not later than 120 days after the close of the fiscal year.

*Code of Ethics.* The Company adopted a written Code of Ethics based upon the standards set forth under Item 406 of Regulation S-K of the Securities Exchange Act. The Code of Ethics applies to all of the Company's directors, officers and employees. A copy of the Company's Code of Ethics was filed with the SEC as Exhibit 14 to the Annual Report on Form 10-K for the year ended December 31, 2004. You may obtain a copy of the Code of Ethics free of charge from the Company by writing to the Corporate Secretary of the Company, 610 Bay Boulevard, Chula Vista, California 91910 or by calling (619) 691-9741. These documents are also available in the corporate governance section of the Company's website at [www.firstpactrustbancorp.com/corporate\\_governance](http://www.firstpactrustbancorp.com/corporate_governance).

*Section 16(a) Beneficial Ownership Reporting Compliance.* The information concerning compliance with the reporting requirements of Section 16(a) of the Securities Exchange Act of 1934 by directors, officers and ten percent stockholders of the Company required by this item is incorporated herein by reference from the Company's definitive proxy statement for its 2004 Annual Meeting of Stockholders, a copy of which will be filed with the Securities and Exchange Commission not later than 120 days after the end of the Company's fiscal year.

*Nomination Procedures.* There have been no material changes to the procedures by which shareholders may recommend nominees to the Company's Board of Directors.

*Audit Committee Matters.* The Board of Directors of the Company has a standing Audit Committee, which has been established in accordance with Section 3(a)(58)(A) of the Exchange Act. The members of that committee are Directors Alvin L. Majors (Chairman), Kenneth W. Scholz, and Donald A. Whitacre, all of whom are considered independent under applicable Nasdaq listing standards. The Board of Directors has determined that Mr. Alvin L. Majors is an audit committee financial expert as defined in applicable SEC rules.

**Item 11. Executive Compensation**

The information concerning executive compensation required by this item is incorporated herein by reference from the Company's definitive proxy statement for its 2008 Annual Meeting of Stockholders, except for information contained under the headings "Compensation Committee report on Executive Compensation, and Report of the Audit Committee," a copy of which will be filed with the Securities and Exchange Commission not later than 120 days after the end of the Company's fiscal year.

**Table of Contents****Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters**

The information concerning security ownership of certain beneficial owners and management required by this item is incorporated herein by reference from the Company's definitive proxy statement for its 2008 Annual Meeting of Stockholders, a copy of which will be filed with the Securities and Exchange Commission not later than 120 days after the end of the Company's fiscal year.

*Equity Compensation Plan Information.* The following table summarizes our equity compensation plans as of December 31, 2007.

| Plan Category  | Number of securities to be issued upon exercise of outstanding options warrants and rights | Weighted-average exercise price of outstanding options warrants and rights | Number of Securities remaining available for future issuance under equity compensation plans |
|--|--|--|--|
| Equity compensation plans approved by security holders     | 690,300  | \$ 17.98   | 19,300(1)  |
| Equity compensation plans not approved by security holders |  |  |  |

- (1) Includes 10,500 shares available for future grants under First PacTrust Bancorp, Inc's stock option plan and 8,800 shares available for future grants under First PacTrust Bancorp, Inc's recognition and retention plan.

**Item 13. Certain Relationships and Related Transactions and Director Independence**

Information concerning certain relationships and related transactions is incorporated herein by reference from the Company's definitive proxy statement for its Annual Meeting of Stockholders to be held in April 2008, except for information contained under the headings "Compensation Committee Report on Executive Compensation" and "Report of the Audit Committee", a copy of which will be filed not later than 120 days after the close of the fiscal year.

The Company has six directors: Alvin L. Majors, Francis P. Burke, Kenneth W. Scholz, Donald M. Purdy, Donald A. Whitacre and Hans R. Ganz. The Board of Directors has determined that Directors Alvin L. Majors, Francis P. Burke, Kenneth W. Scholz, Donald M. Purdy and Donald A. Whitacre, who constitute a majority of the Board members, are independent directors as defined in the Nasdaq listing standards. All the members of the Company's standing Audit/Compliance, Compensation and Nominating Committees are independent under these standards and the independence standards set for each of those committees in their charters. These committee charters are available on the Company's website at [www.pacifictrustbank.com](http://www.pacifictrustbank.com).

**Item 14. Principal Accountant Fees and Services**

- (a) Information concerning principal accountant fees and services is incorporated herein by reference from the definitive proxy statement for the Annual Meeting of Stockholders to be held on April 18, 2008 (excluding the information contained and the heading of "Report of the Audit/Compliance Committee"). A copy of such will be filed no later than 120 days after December 31, 2007.

**Table of Contents****PART IV****Item 15. Exhibits and Financial Statement Schedules**

- (a)(1) Financial Statements: See Part II Item 8. Financial Statements and Supplementary Data  
(a)(2) Financial Statement Schedule: All financial statement schedules have been omitted as the information is not required under the related instructions or is not applicable.  
(a)(3) Exhibits

| Regulation S-K<br>Exhibit Number | Document  | Reference to<br>Prior Filing<br>or Exhibit Number<br>Attached Hereto |
|----------------------------------|---|--|
| 2.0                              | Plan of acquisition, reorganization, arrangement, liquidation or succession                             | None   |
| 3.1                              | Charter for First PacTrust Bancorp, Inc.  | *  |
| 3.2                              | Bylaws of First PacTrust Bancorp, Inc.  | *  |
| 4.0                              | Form of Stock Certificate of First PacTrust Bancorp, Inc.   | *  |
| 9.0                              | Voting Trust Agreement  | None   |
| 10.1                             | Severance Agreement with Hans Ganz  | ***  |
| 10.2                             | Severance Agreement with Melanie Stewart  | ***  |
| 10.3                             | Severance Agreement with James P. Sheehy  | ***  |
| 10.4                             | 401(k) Employee Stock Ownership Plan  | *  |
| 10.5                             | Registrant's Stock Option and Incentive Plan  | **   |
| 10.6                             | Registrant's Recognition and Retention Plan   | **   |
| 10.7                             | Named Executive Officers Salary and Bonus Arrangements for 2008 and Director Fee Arrangements for 2008. | 10.7   |
| 11.0                             | Statement regarding computation of ratios   | None   |
| 14.0                             | Code of Ethics  | ***  |
| 16.0                             | Letter regarding change in certifying accountant  | None   |
| 18.0                             | Letter regarding change in accounting principles  | None   |
| 21.0                             | Subsidiaries of the Registrant  | *  |
| 22.0                             | Published Report regarding matters submitted to vote of security holders                                | None   |
| 23.0                             | Consent of Crowe Chizek and Company LLP   | 23.0   |
| 24.0                             | Power of Attorney, included in signature pages  | 24.0   |
| 31.1                             | Rule 13(a)-14(a) Certification (Chief Executive Officer)  | 31.1   |
| 31.2                             | Rule 13(a)-14(a) Certification (Chief Financial Officer)  | 31.2   |
| 32.0                             | Section 1350 of The Sarbanes-Oxley Act Certification  | 32   |

\*

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Filed in First PacTrust's Registration Statement on Form S-1. Filed on March 28, 2002. Such information is hereby incorporated by reference.

\*\* Filed as an appendix to the Registrant's definitive proxy statement filed on March 21, 2003. Such previously filed document is incorporated herein by reference in accordance with Item 601 of Regulation S-K.

\*\*\* Filed as an Exhibit to the Company's annual report on Form 10-K for the year ended December 31, 2005.

(b) Exhibits Included, see list in (a)(3).

(c) Financial Statement Schedules None

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**SIGNATURES**

Pursuant to the requirements of Section 13 or 15 (d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned hereunto duly authorized.

**FIRST PACTRUST BANCORP, INC.**

Date: March 10, 2008

By: /s/ HANS R. GANZ  
**Hans R. Ganz, President and Chief Executive Officer**  
*(Duly Authorized Representative)*

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

/s/ HANS R. GANZ  
**Hans R. Ganz, President,**  
**Chief Executive Officer and Director**

/s/ ALVIN L. MAJORS  
**Alvin L. Majors,**  
**Chairman of the Board**

/s/ FRANCIS P. BURKE  
**Francis P. Burke,**

/s/ KENNETH W. SCHOLZ  
**Kenneth W. Scholz,**  
**Director**

**Director**

/s/ DONALD M. PURDY  
**Donald M. Purdy,**

/s/ DONALD A. WHITACRE  
**Donald A. Whitacre,**  
**Director**

**Director**

/s/ REGAN J. LAUER  
**Regan J. Lauer, Senior Vice President/Controller**

*(Principal Financial and Accounting Officer)*