

CENTRAL PACIFIC FINANCIAL CORP  
Form 10-Q  
November 08, 2006

# UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

## FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2006

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 0-10777

## CENTRAL PACIFIC FINANCIAL CORP.

(Exact name of registrant as specified in its charter)

**Hawaii**  
(State or other jurisdiction of  
incorporation or organization)  
**220 South King Street, Honolulu, Hawaii**  
(Address of principal executive offices)

**99-0212597**  
(I.R.S. Employer  
Identification No.)  
**96813**  
(Zip Code)

**(808)544-0500**

(Registrant's telephone number, including area code)

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Edgar Filing: CENTRAL PACIFIC FINANCIAL CORP - Form 10-Q

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

As of October 29, 2006, the number of shares of common stock outstanding of the registrant was 30,667,310 shares.

---

CENTRAL PACIFIC FINANCIAL CORP. AND SUBSIDIARIES

Table of Contents

		Page
<b>Part I.</b>	<b><u>Financial Information</u></b>	
<u>Item 1.</u>	<u>Financial Statements (Unaudited)</u>	
	<u>Consolidated Balance Sheets</u> <u>September 30, 2006 and 2005, and December 31, 2005</u>	
	<u>Consolidated Statements of Income</u> <u>Three and nine months ended September 30, 2006 and 2005</u>	
	<u>Consolidated Statements of Changes in Shareholders' Equity and Comprehensive Income</u> <u>Nine months ended September 30, 2006 and 2005</u>	
	<u>Consolidated Statements of Cash Flows</u> <u>Nine months ended September 30, 2006 and 2005</u>	
	<u>Notes to Consolidated Financial Statements</u>	
<u>Item 2.</u>	<u>Management's Discussion and Analysis of Results of Operations and Financial Condition</u>	
<u>Item 3.</u>	<u>Quantitative and Qualitative Disclosures About Market Risk</u>	
<u>Item 4.</u>	<u>Controls and Procedures</u>	
<b>Part II.</b>	<b><u>Other Information</u></b>	
<u>Item 1.</u>	<u>Legal Proceedings</u>	
<u>Item 1A.</u>	<u>Risk Factors</u>	
<u>Item 2.</u>	<u>Unregistered Sales of Equity and Use of Proceeds</u>	
<u>Item 3.</u>	<u>Defaults Upon Senior Securities</u>	
<u>Item 4.</u>	<u>Submission of Matters to a Vote of Security Holders</u>	
<u>Item 5.</u>	<u>Other Information</u>	
<u>Item 6.</u>	<u>Exhibits</u>	
<b><u>Signatures</u></b>		
<b>Exhibit Index</b>		

**PART I. FINANCIAL INFORMATION**

**Forward-Looking Statements**

This document may contain forward-looking statements concerning projections of revenues, income, earnings per share, capital expenditures, dividends, capital structure, or other financial items, concerning plans and objectives of management for future operations, concerning future economic performance, or concerning any of the assumptions underlying or relating to any of the foregoing. Forward-looking statements can be identified by the fact that they do not relate strictly to historical or current facts, and may include the words "believes", "plans", "intends", "expects", "anticipates", "forecasts" or words of similar meaning. While we believe that our forward-looking statements and the assumptions underlying them are reasonably based, such statements and assumptions are by their nature subject to risks and uncertainties, and thus could later prove to be inaccurate or incorrect. Accordingly, actual results could materially differ from projections for a variety of reasons, to include, but not limited to: the impact of local, national, and international economies and events (including natural disasters) on the Company's business and operations and on tourism, the military, and other major industries operating within the Hawaii market; the impact of legislation affecting the banking industry; the impact of competitive products, services, pricing, and other competitive forces; movements in interest rates; loan delinquency rates and changes in asset quality; and the price of the Company's stock. For further information on factors that could cause actual results to materially differ from projections, please see the Company's publicly available Securities and Exchange Commission filings, including the Company's Form 10-K for the last fiscal year. The Company does not update any of its forward-looking statements.

3

---

## Item 1. Financial Statements

**CENTRAL PACIFIC FINANCIAL CORP. AND SUBSIDIARIES**  
**CONSOLIDATED BALANCE SHEETS**  
(Unaudited)

(Dollars in thousands)	September 30, 2006	December 31, 2005	September 30, 2005
<b>Assets</b>			
Cash and due from banks	\$ 110,554	\$ 154,927	\$ 111,223
Interest-bearing deposits in other banks	9,472	9,813	15,971
Investment securities:			
Held to maturity, at amortized cost (fair value of \$65,821 at September 30, 2006, \$70,651 at December 31, 2005, and \$76,515 at September 30, 2005)	66,918	71,843	77,418
Available for sale, at fair value	832,255	853,442	871,942
Total investment securities	899,173	925,285	949,360
Loans held for sale	21,742	60,538	53,970
Loans	3,765,081	3,552,749	3,366,620
Less allowance for loan losses	52,611	52,936	52,745
Net loans	3,712,470	3,499,813	3,313,875
Premises and equipment	76,909	72,568	72,982
Accrued interest receivable	25,631	22,006	20,787
Investment in unconsolidated subsidiaries	11,160	12,417	12,298
Due from customers on acceptances	271	530	202
Goodwill	298,121	303,358	299,232
Core deposit premium	32,872	35,795	37,450
Mortgage servicing rights	11,794	11,820	11,848
Bank-owned life insurance	101,101	68,325	67,799
Federal Home Loan Bank stock	48,797	48,797	48,797
Other assets	18,823	13,147	25,768
Total assets	\$ 5,378,890	\$ 5,239,139	\$ 5,041,562
<b>Liabilities and shareholders' equity</b>			
<b>Deposits:</b>			
Noninterest-bearing demand	\$ 608,229	\$ 730,952	\$ 659,699
Interest-bearing demand	433,437	442,879	432,530
Savings and money market	1,204,488	1,091,057	1,136,418
Time	1,535,769	1,377,356	1,242,150
Total deposits	3,781,923	3,642,244	3,470,797
Short-term borrowings	58,773	82,734	114,448
Long-term debt	730,784	749,258	709,685
Bank acceptances outstanding	271	530	202
Minority interest	13,515	13,157	13,541
Other liabilities	70,686	74,982	67,881
Total liabilities	4,655,952	4,562,905	4,376,554
<b>Shareholders' equity:</b>			
Preferred stock, no par value, authorized 1,000,000 shares, none issued			
Common stock, no par value, authorized 100,000,000 shares; issued and outstanding 30,659,972 shares at September 30, 2006, 30,436,862 shares at December 31, 2005, and 30,412,482 shares at September 30, 2005	430,204	428,012	427,458

Edgar Filing: CENTRAL PACIFIC FINANCIAL CORP - Form 10-Q

Surplus	50,612	46,432	46,362
Retained earnings	258,880	218,341	204,765
Deferred stock awards		(612)	(280)
Accumulated other comprehensive loss	(16,758)	(15,939)	(13,297)
Total shareholders' equity	722,938	676,234	665,008
Total liabilities and shareholders' equity	\$ 5,378,890	\$ 5,239,139	\$ 5,041,562

*See accompanying notes to unaudited consolidated financial statements.*

**CENTRAL PACIFIC FINANCIAL CORP. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF INCOME**  
**(Unaudited)**

(Dollars in thousands, except per share data)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
<b>Interest income:</b>				
Interest and fees on loans	\$ 72,444	\$ 56,366	\$ 204,603	\$ 161,338
<b>Interest and dividends on investment securities:</b>				
Taxable interest	8,486	8,980	25,996	24,377
Tax-exempt interest	1,227	1,297	3,822	3,932
Dividends	153	93	264	228
Interest on deposits in other banks	79	37	306	242
Interest on Federal funds sold and securities purchased under agreements to resell	31	87	85	166
Dividends on Federal Home Loan Bank stock				272
<b>Total interest income</b>	<b>82,420</b>	<b>66,860</b>	<b>235,076</b>	<b>190,555</b>
<b>Interest expense:</b>				
Interest on deposits	19,155	9,969	49,424	26,491
Interest on short-term borrowings	1,221	319	2,035	1,159
Interest on long-term debt	8,949	6,998	26,163	18,501
<b>Total interest expense</b>	<b>29,325</b>	<b>17,286</b>	<b>77,622</b>	<b>46,151</b>
<b>Net interest income</b>	<b>53,095</b>	<b>49,574</b>	<b>157,454</b>	<b>144,404</b>
Provision for loan losses	300	1,000	1,350	2,917
<b>Net interest income after provision for loan losses</b>	<b>52,795</b>	<b>48,574</b>	<b>156,104</b>	<b>141,487</b>
<b>Other operating income:</b>				
Income from fiduciary activities	740	649	2,157	1,763
Service charges on deposit accounts	3,570	3,383	10,563	8,281
Other service charges and fees	2,994	2,915	8,993	8,288
Equity in earnings of unconsolidated subsidiaries	90	251	421	541
Fees on foreign exchange	207	188	601	594
Loan placement fees	464	738	1,256	1,169
Gains on sales of loans	680	1,617	4,133	3,039
Investment securities gains (losses)		(23)	(19)	1,423
Income from bank-owned life insurance	1,085	522	2,794	1,670
Other	715	1,234	2,770	2,761
<b>Total other operating income</b>	<b>10,545</b>	<b>11,474</b>	<b>33,669</b>	<b>29,529</b>
<b>Other operating expense:</b>				
Salaries and employee benefits	17,451	17,594	54,128	48,046
Net occupancy	2,399	2,516	6,974	7,560
Equipment	1,171	1,196	3,624	3,721
Amortization of core deposit premium	974	1,656	2,922	4,611
Communication expense	1,186	947	3,562	3,100
Legal and professional services	1,985	1,600	6,174	5,960
Computer software expense	716	553	1,956	2,221
Advertising expense	515	662	1,789	1,920
Other	4,819	5,617	15,324	14,825
<b>Total other operating expense</b>	<b>31,216</b>	<b>32,341</b>	<b>96,453</b>	<b>91,964</b>
<b>Income before income taxes</b>	<b>32,124</b>	<b>27,707</b>	<b>93,320</b>	<b>79,052</b>
Income taxes	11,521	9,710	32,940	25,948
<b>Net income</b>	<b>\$ 20,603</b>	<b>\$ 17,997</b>	<b>\$ 60,380</b>	<b>\$ 53,104</b>

Per share data:

Edgar Filing: CENTRAL PACIFIC FINANCIAL CORP - Form 10-Q

Basic earnings per share	\$ 0.67	\$ 0.59	\$ 1.98	\$ 1.78
Diluted earnings per share	0.67	0.58	1.96	1.75
Cash dividends declared	0.23	0.19	0.65	0.54
Basic weighted average shares outstanding	30,532	30,401	30,465	29,804
Diluted weighted average shares outstanding	30,838	30,836	30,790	30,266

*See accompanying notes to unaudited consolidated financial statements.*

5

---



## CENTRAL PACIFIC FINANCIAL CORP. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS EQUITY AND  
COMPREHENSIVE INCOME

(Unaudited)

(Dollars in thousands, except per share data)	Common Stock	Surplus	Retained Earnings	Deferred Stock Awards	Accumulated Other Comprehensive Loss	Total
<b>Nine months ended September 30, 2006</b>						
Balance at December 31, 2005	\$ 428,012	\$ 46,432	\$ 218,341	\$ (612 )	\$ (15,939 )	\$ 676,234
Net income			60,380			60,380
Net change in unrealized loss on investment securities, net of taxes of \$583					(819 )	(819 )
Comprehensive income						59,561
Cash dividends (\$0.65 per share)			(19,841 )			(19,841 )
849 shares of common stock purchased by directors deferred compensation plan	(32 )					(32 )
212,700 shares of common stock issued in conjunction with stock option exercises	2,947					2,947
10,410 shares of common stock issued under stock plans		260				260
Share-based compensation		2,580				2,580
Tax benefit related to stock options exercises		675				675
Reclassification of share-based plans	(723 )	665		612		554
Balance at September 30, 2006	\$ 430,204	\$ 50,612	\$ 258,880	\$	\$ (16,758 )	\$ 722,938
Disclosure of reclassification amount:						
Unrealized holding loss on investment securities during period, net of taxes of \$572	\$	\$	\$	\$	\$ (803 )	\$ (803 )
Less reclassification adjustment for losses included in net income, net of taxes of \$11					16	16
Net change in unrealized loss on investment securities	\$	\$	\$	\$	\$ (819 )	\$ (819 )
<b>Nine months ended September 30, 2005</b>						
Balance at December 31, 2004	\$ 360,550	\$ 45,848	\$ 167,801	\$ (174 )	\$ (6,163 )	\$ 567,862
Net income			53,104			53,104
Net change in unrealized loss on investment securities, net of taxes of \$4,834					(7,134 )	(7,134 )
Comprehensive income						45,970
Cash dividends (\$0.54 per share)			(16,071 )			(16,071 )
2,012,500 shares issued in conjunction with common stock offering	64,210					64,210
239,125 shares of common stock issued in conjunction with stock option exercises	2,626					2,626
1,181 shares of common stock purchased by directors deferred compensation plan	(46 )					(46 )
2,893 shares of common stock repurchased	(37 )		(69 )			(106 )

Edgar Filing: CENTRAL PACIFIC FINANCIAL CORP - Form 10-Q

4,355 shares of deferred stock awards granted	155			(155	)		
Amortization of deferred stock awards				49		49	
Tax impact of nonqualified stock options exercised	514					514	
Balance at September 30, 2005	\$ 427,458	\$ 46,362	\$ 204,765	\$ (280	)	\$ (13,297	) \$ 665,008
Disclosure of reclassification amount:							
Unrealized holding loss on investment securities during period, net of taxes of \$4,771	\$	\$	\$	\$	\$	(7,039	) \$ (7,039
Less reclassification adjustment for gains included in net income, net of taxes of \$63					95	95	
Net change in unrealized loss on investment securities	\$	\$	\$	\$	\$	(7,134	) \$ (7,134

*See accompanying notes to unaudited consolidated financial statements.*

**CENTRAL PACIFIC FINANCIAL CORP. AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(Unaudited)

(Dollars in thousands)	Nine Months Ended September 30,	
	2006	2005
<b>Cash flows from operating activities:</b>		
Net income	\$ 60,380	\$ 53,104
<b>Adjustments to reconcile net income to net cash provided by operating activities:</b>		
Provision for loan losses	1,350	2,917
Provision for depreciation and amortization	5,150	5,786
Amortization of intangible assets	4,619	5,697
Net amortization of deferred stock awards		50
Net amortization of investment securities	2,236	3,162
Share-based compensation	2,580	
Net loss (gain) on investment securities	19	(1,423 )
Net gain on sale of loans	(4,133 )	(3,323 )
Proceeds from sales of loans held for sale	413,756	197,927
Originations of loans held for sale	(370,827 )	(230,838 )
Tax benefits from share-based compensation	(675 )	
Deferred income tax expense	24	14,713
Equity in earnings of unconsolidated subsidiaries	(421 )	(541 )
Net change in other assets and other liabilities	(41,561 )	(35,922 )
<b>Net cash provided by operating activities</b>	<b>72,497</b>	<b>11,309</b>
<b>Cash flows from investing activities:</b>		
Proceeds from maturities of and calls on investment securities held to maturity	4,685	23,298
Proceeds from sales of investment securities available for sale	57	121,524
Proceeds from maturities of and calls on investment securities available for sale	392,151	595,998
Purchases of investment securities available for sale	(374,439 )	(853,066 )
Net loan originations	(212,955 )	(236,891 )
Purchases of premises and equipment	(9,491 )	(4,968 )
Distributions from unconsolidated subsidiaries	768	536
Contributions to unconsolidated subsidiaries		(1,998 )
Acquisition of Hawaii HomeLoans, Inc., net of cash and cash equivalents acquired		(8,300 )
<b>Net cash used in investing activities</b>	<b>(199,224 )</b>	<b>(363,867 )</b>
<b>Cash flows from financing activities:</b>		
Net increase in deposits	139,679	143,677
Proceeds from long-term debt	75,000	150,000
Repayments of long-term debt	(92,486 )	(26,092 )
Net decrease in short-term borrowings	(23,961 )	(2,452 )
Cash dividends paid	(19,841 )	(16,071 )
Tax benefits from share-based compensation	675	
Proceeds from common stock offering		67,312
Proceeds from stock option exercises	2,947	
Repurchases of common stock		(69 )
<b>Net cash provided by financing activities</b>	<b>82,013</b>	<b>316,305</b>
<b>Net decrease in cash and cash equivalents</b>	<b>(44,714 )</b>	<b>(36,253 )</b>
<b>Cash and cash equivalents:</b>		

Edgar Filing: CENTRAL PACIFIC FINANCIAL CORP - Form 10-Q

At beginning of period	164,740	163,447
At end of period	\$ 120,026	\$ 127,194
Supplemental disclosure of cash flow information:		
Cash paid during the period for:		
Interest	\$ 74,354	\$ 43,176
Income taxes	25,517	33,942
Cash received during the period for:		
Income taxes	3,255	10,498
Supplemental disclosure of noncash investing and financing activities:		
Net change in common stock held by directors deferred compensation plan	\$ 32	\$ 46

*See accompanying notes to unaudited consolidated financial statements.*

7

---

**CENTRAL PACIFIC FINANCIAL CORP. AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
(Unaudited)

**1. BASIS OF PRESENTATION**

The accompanying unaudited consolidated financial statements of Central Pacific Financial Corp. (the Company) have been prepared in accordance with U.S. generally accepted accounting principles (GAAP) for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, certain information and footnote disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted pursuant to such rules and regulations. These interim condensed consolidated financial statements and notes should be read in conjunction with the Company's consolidated financial statements and notes thereto filed on Form 10-K for the fiscal year ended December 31, 2005. In the opinion of management, all adjustments necessary for a fair presentation have been made and include all normal recurring adjustments. Interim results of operations are not necessarily indicative of results to be expected for the year.

Certain prior period amounts in the condensed consolidated financial statements and notes thereto have been reclassified to conform to the current period presentation. Such reclassifications had no impact on net income or shareholders' equity for any periods presented.

**2. RECENTLY ISSUED ACCOUNTING PRONOUNCEMENTS**

In February 2006, the Financial Accounting Standards Board (FASB) issued SFAS No. 155, Accounting for Certain Hybrid Financial Instruments, an amendment of FASB Statements No. 133 and 140 (SFAS 155). SFAS 155 amends the guidance in SFAS 133, Accounting for Derivative Instruments and Hedging Activities, and SFAS 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities. SFAS 155 permits fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation, clarifies which interest-only strips and principal-only strips are not subject to the requirements of SFAS 133, establishes a requirement to evaluate interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation, clarifies that concentrations of credit risk in the form of subordination are not embedded derivatives and amends SFAS 140 to eliminate the prohibition on a qualifying special-purpose entity from holding a derivative financial instrument that pertains to a beneficial interest other than another derivative financial instrument. SFAS 155 is effective for all financial instruments acquired beginning January 1, 2007. The Company is evaluating the impact of this new pronouncement on its consolidated financial statements.

In March 2006, the FASB issued SFAS No. 156, Accounting for Servicing of Financial Assets, an amendment of FASB Statement No. 140 (SFAS 156). SFAS 156 requires all separately recognized servicing assets and servicing liabilities to be initially measured at fair value and permits an entity to choose to either amortize servicing assets or servicing liabilities in

proportion to and over the period of estimated net servicing income or net servicing loss and assess servicing assets or servicing liabilities for impairment or increased obligation based on fair value at each reporting date, or measure servicing assets or servicing liabilities at fair value at each reporting date and report changes in fair value in earnings in the period in which the changes occur. SFAS 156 also permits a one-time reclassification of available-for-sale securities to trading securities by entities with recognized servicing rights, provided that the available-for-sale securities are identified as offsetting the entity's exposure to changes in fair value of servicing assets or servicing liabilities that a servicer elects to subsequently measure at fair value, requires separate presentation of servicing assets and servicing liabilities subsequently measured at fair value and specifies additional disclosures for all separately recognized servicing assets and servicing liabilities. SFAS 156 is effective as of the beginning of the entity's first fiscal year that begins after September 15, 2006. The Company plans to adopt SFAS 156 on January 1, 2007, and does not expect such adoption to have a material impact on its consolidated financial statements.

In June 2006, the FASB issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes. The interpretation clarifies the accounting for uncertainty in income taxes recognized in a company's financial statements in accordance with SFAS No. 109, Accounting for Income Taxes. Specifically, the pronouncement prescribes a recognition threshold and a measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. The interpretation also provides guidance on the related derecognition, classification, interest and penalties, accounting for interim periods, disclosure and transition of uncertain tax positions. The interpretation is effective for fiscal years beginning after December 15, 2006. The Company is evaluating the impact of this new pronouncement on its consolidated financial statements.

In September 2006, the Emerging Issues Task Force (EITF) reached a consensus on EITF No. 06-4, Accounting for Deferred Compensation and Postretirement Benefits Aspects of Endorsement Split-Dollar Life Insurance Arrangements (EITF 06-4). EITF 06-4 requires that, for split-dollar life insurance arrangements that provide a benefit to an employee that extends to postretirement periods, an employer should recognize a liability for future benefits in accordance with SFAS No. 106. EITF 06-4 is effective for fiscal years beginning after December 15, 2007 and it requires that recognition of the effects of adoption should be either by (a) a change in accounting principle through a cumulative-effect adjustment to retained earnings as of the beginning of the year of adoption or (b) a change in accounting principle through retrospective application to all prior periods. The Company is currently evaluating the impact of EITF 06-4 on its consolidated financial statements.

In September 2006, the EITF reached a consensus on EITF No. 06-5, Accounting for Purchases of Life Insurance - Determining the Amount that Could Be Realized in Accordance with FASB Tech Bulletin 85-4 (EITF 06-5). The EITF concluded that a policyholder should consider any additional amounts included in the contractual terms of the life insurance policy in determining the amount that could be realized under the insurance contract on a policy by policy basis. EITF 06-5 is effective for fiscal years beginning after December 15, 2006 and it requires that recognition of the effects of adoption should be either by (a) a change in accounting

principle through a cumulative-effect adjustment to retained earnings as of the beginning of the year of adoption or (b) a change in accounting principle through retrospective application to all prior periods. The Company is currently evaluating the impact of EITF 06-5 on its consolidated financial statements.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements ( SFAS 157 ). The standard defines fair value, establishes a framework for measuring fair value in accounting principles generally accepted in the United States of America and expands disclosure about fair value measurements. The pronouncement applies under other accounting standards that require or permit fair value measurements. Accordingly, the statement does not require any new fair value measurement. SFAS 157 is effective for fiscal years beginning after November 15, 2007 and the Company plans to adopt SFAS 157 on January 1, 2008. The Company is evaluating the requirements of SFAS 157 and has not yet determined the impact on its consolidated financial statements.

In September 2006, the FASB issued SFAS No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans an amendment of FASB Statements No. 87, 88, 106, and 132(R) ( SFAS 158 ). The statement requires an employer to recognize the overfunded or underfunded status of a defined benefit postretirement plan (other than a multiemployer plan) as an asset or liability on its statement of financial position. SFAS 158 also requires an employer to recognize changes in that funded status in the year in which the changes occur through other comprehensive income. The provisions of the statement also require an employer to measure the funded status of a plan as of the date of its year-end statement of financial position, with limited exceptions. SFAS 158 is effective for fiscal years ending after December 15, 2006. Accordingly, the Company will be required to adopt SFAS 158 for the current fiscal year ending December 31, 2006. The Company is evaluating the requirements of SFAS 158 and has not yet determined the impact on its consolidated financial statements.

In September 2006, the Securities and Exchange Commission ( SEC ) issued Staff Accounting Bulletin No. 108 Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements ( SAB 108 ). SAB 108 states that registrants should use both a balance sheet approach and an income statement approach when quantifying and evaluating the materiality of a misstatement. The interpretations in SAB 108 contain guidance on correcting errors under the dual approach as well as provide transition guidance for correcting errors. This interpretation does not change the requirements within SFAS No. 154, Accounting Changes and Error Corrections a replacement of APB No. 20 and FASB Statement No. 3, for the correction of an error on financial statements. SAB 108 is effective for annual financial statements covering the first fiscal year ending after November 15, 2006. The Company is currently evaluating the requirements of SAB 108 and has not yet determined the impact on its consolidated financial statements.

### **3. SHARE-BASED COMPENSATION**

Effective January 1, 2006, the Company adopted the fair value recognition provisions of SFAS No. 123, Share-Based Payment ( SFAS 123R ). SFAS 123R requires all share-based

payments to employees, including grants of employee stock options and restricted stock awards, to be recognized in the financial statements based on their respective grant date fair values. The Company elected to use the modified prospective transition method as permitted by SFAS 123R. Under this transition method, compensation expense recognized by the Company beginning in 2006 includes (a) compensation expense for all share-based compensation awards granted prior to, but not yet vested as of January 1, 2006, based on the grant-date fair value estimated in accordance with the original provisions of SFAS 123, Accounting for Stock-Based Compensation, as adjusted for estimated forfeitures and (b) compensation expense for all share-based compensation awards granted subsequent to January 1, 2006, based on the grant-date fair value estimated in accordance with the provisions of SFAS 123R. The Company recognizes compensation expense for all share-based payment awards on a straight-line basis over the respective requisite service period of the awards, which is generally the vesting period.

Prior to January 1, 2006, as permitted by SFAS 123, the Company accounted for its share-based payment plans in accordance with the provisions of Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees, and related interpretations, whereby compensation expense was recorded on the date of grant only if the current market price of the underlying stock exceeded the exercise price. Costs of restricted stock awards granted, determined to be the fair market value of the shares at the date of grant, have been recognized as compensation expense ratably over the respective vesting period.

The following table summarizes the effects of share-based compensation resulting from the application of SFAS 123R to options and awards granted under the Company's equity incentive plans:

(Dollars in thousands)	Three Months Ended September 30, 2006	Nine Months Ended September 30, 2006
Salaries and employee benefits	\$ 878	\$ 2,580
Income tax benefit	(352)	(1,034)
Net share-based compensation effect	\$ 526	\$ 1,546

In accordance with SFAS 123R, the Company is required to base initial share-based compensation expense on the estimated number of awards for which the requisite service and performance is expected to be rendered. Historically, and as permitted under SFAS 123R, the Company chose to record reductions in compensation expense in the periods the awards were forfeited. The cumulative effect of the change to an estimated number of awards for which the requisite service and performance is expected to be rendered resulted in a reduction of salary expense of \$0.2 million in the Consolidated Statements of Income.

### Stock Option Plans

The Company has adopted stock option plans for the purpose of granting options to purchase the Company's common stock to directors, officers and other key individuals. Option awards are generally granted with an exercise price equal to the market price of the Company's common stock at the date of grant; those option awards generally vest based on three or five years of



continuous service and have 10-year contractual terms. Certain option and share awards provide for accelerated vesting if there is a change in control (as defined in the stock option plans below).

In February 1997, the Company adopted the 1997 Stock Option Plan ( 1997 Plan ) basically as a continuance of the 1986 Stock Option Plan. In April 1997, the Company's shareholders approved the 1997 Plan, which provided 2,000,000 shares of the Company's common stock for grants to employees as qualified incentive stock options and to directors as nonqualified stock options.

In September 2004, the Company adopted and the Company's shareholders approved the 2004 Stock Compensation Plan ( 2004 Plan ) making available 1,989,224 shares for grants to employees and directors. Upon adoption of the 2004 Plan, all unissued shares from the 1997 Plan were frozen and no new options will be granted under the 1997 Plan. Optionees may exercise outstanding options granted pursuant to the 1997 Plan until the expiration of the respective options in accordance with the original terms of the 1997 Plan. To satisfy share issuances pursuant to the share-based compensation programs, the Company issues new shares from the 2004 Plan.

The fair value of each option award is estimated on the date of grant based on the following:

*Valuation and amortization method* The Company estimates the fair value of stock options granted using the Black-Scholes option pricing formula and a single option award approach. The Company uses historical data to estimate option exercise and employee termination activity within the valuation model; separate groups of employees that have similar historical exercise behavior are considered separately for valuation purposes. This fair value is then amortized on a straight-line basis over the requisite service periods of the awards, which is generally the vesting period.

*Expected life* The expected life of options represents the period of time that options granted are expected to be outstanding.

*Expected volatility* Expected volatilities are based on the historical volatility of the Company's common stock.

*Risk-free interest rate* The risk-free interest rate for periods within the contractual life of the option is based on the U.S. Treasury yield curve in effect at the time of grant.

*Expected dividend* The expected dividend assumption is based on the Company's current expectations about its anticipated dividend policy.

Edgar Filing: CENTRAL PACIFIC FINANCIAL CORP - Form 10-Q

The fair value of the Company's stock options granted to employees for the three and nine months ended September 30, 2006 was estimated using the following weighted-average assumptions:

	<b>Three and Nine Months Ended September 30, 2006</b>	
Expected volatility	34.4	%
Risk free interest rate	4.9	%
Expected dividends	2.4	%
Expected life	6.5 years	
Weighted average fair value	\$	11.99

There were no grants of stock options for the three and nine months ended September 30, 2005.

As of September 30, 2006, the total compensation cost related to stock options granted to employees under the Company's stock option plans but not yet recognized was approximately \$3.8 million, net of estimated forfeitures. This cost will be amortized on a straight-line basis over a weighted-average period of 1.9 years and will be adjusted for subsequent changes in estimated forfeitures. The total fair value of shares vested during each of the three and nine months ended September 30, 2006 and 2005 was \$0.4 million and \$1.0 million, respectively.

The following is a summary of option activity for the Company's stock option plans:

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value (in thousands)
Outstanding at January 1, 2006	1,289,645	\$ 23.50		
Changes during the year:				
Granted	4,000	35.11		
Exercised	(212,700)	) 13.85		
Expired	(560)	) 27.82		
Forfeited	(37,607)	) 35.39		
Outstanding at September 30, 2006	1,042,778	\$ 25.08	6.5	\$ 11,994
Vested and expected to vest at September 30, 2006	1,014,867	\$ 24.84	6.5	\$ 11,914
Exercisable at September 30, 2006	581,347	\$ 18.95	5.0	\$ 10,249

The aggregate intrinsic value is calculated as the difference between the exercise price of the underlying option awards and the quoted price of the Company's common stock for the options that were in-the-money at September 30, 2006. During the three and nine months ended September 30, 2006, the aggregate intrinsic value of options exercised under the Company's

stock option plans was \$4.0 million and \$4.7 million, respectively, determined as of the date of exercise. The aggregate intrinsic value of options exercised during the three and nine months ended September 30, 2005 was less than \$0.1 million and \$5.9 million, respectively, determined as of the date of exercise.

### Restricted Stock Awards

Under the 1997 and 2004 Plans, the Company awarded restricted stock awards to its non-officer directors and certain senior management personnel. The awards typically vest over a three or five year period. Compensation expense is measured as the market price of the stock awards on the grant date, and is recognized over the specified vesting periods.

As of September 30, 2006, there was \$0.5 million of total unrecognized compensation cost related to restricted stock awards that is expected to be recognized over a weighted-average period of 2.5 years.

The table below presents the activity of restricted stock awards for the nine months ended September 30, 2006.

	Shares	Weighted Average Grant Date Fair Value
Nonvested at January 1, 2006	20,420	\$ 33.36
Changes during the year:		
Granted	3,000	35.10
Vested	(900 )	14.50
Nonvested at September 30, 2006	22,520	34.35
Vested and expected to vest at September 30, 2006	22,520	34.35

### Performance Shares and Stock Appreciation Rights

In 2005, the Company established a Long Term Incentive Plan ( LTIP ) that covers certain executive and senior management personnel. The LTIP is comprised of three components: performance shares, stock appreciation rights, and cash awards.

Performance shares are granted under the 2004 Plan and vest based on achieving both performance and service conditions. Performance conditions require achievement of stated goals including earnings per share, credit quality and efficiency ratio targets. The service condition requires employees to be employed continuously with the Company through March 15, 2008. The fair value of the grant to be recognized over this service period is determined based on the market value of the stock on the grant date, multiplied by the probability of the granted shares being earned. This requires the Company to assess the expectation over the performance period of the performance targets being achieved as well as to estimate expected pre-vested

cancellations. To the extent that the actual achievement falls short of the originally determined expectation (probability), then there is no adjustment to reduce the remaining compensation cost to be recognized. If, on the other hand, the actual achievement exceeds the expected achievement, then compensation cost is adjusted for the reporting period and over the remaining service period to reflect the increased expected compensation cost.

As of September 30, 2006, there was \$1.3 million of total unrecognized compensation cost related to performance shares that is expected to be recognized over a weighted-average period of 1.5 years.

The table below presents activity of performance shares for the nine months ended September 30, 2006:

	Shares	Weighted Average Grant Date Fair Value
Nonvested at January 1, 2006	94,698	\$ 34.43
Changes during the year:		
Granted	6,737	35.67
Forfeited	(18,420 )	33.77
Nonvested at September 30, 2006	83,015	34.68
Vested and expected to vest at September 30, 2006	69,973	34.53

Stock appreciation rights ( SARs ) are granted under the 2004 Plan. These SARs require the employee to achieve the same performance conditions as the performance shares described above as well as to satisfy service conditions that approximate three years from the date of grant. Upon exercise of the SAR, for each SAR exercised, the grantee shall be entitled to receive value equal to the difference between the market value of a share on the date of exercise minus the market value of a share on the date of grant. The Company shall pay the value owing to the grantee upon exercise in whole shares. No cash will be awarded upon exercise, and no fractional shares will be issued or delivered.

As the SARs plan is a stock-settled SAR, this plan is an equity-classified award under SFAS 123R. As such, the financial and income tax accounting for this type of award is identical to that of a nonqualified stock option plan. Therefore, the grant date fair value is determined at grant date using the same method as would be used for determining the fair value of a grant of a nonqualified stock option, which has historically been the Black-Scholes formula. Similar to the performance shares addressed above, the amount of compensation cost to be recognized is the fair value of the SAR grant adjusted based on expectations of achieving the performance requirements and also the expected pre-vested cancellations. Compensation costs arising from the SARs will be recognized ratably over the requisite service period.

The fair value of SARs granted to employees for the three and nine months ended September 30, 2006 was estimated using Black-Scholes option pricing formula with the following weighted-average assumptions:

	Three Months Ended September 30, 2006		Nine Months Ended September 30, 2006		2005	
		%		%		%
Expected volatility	33.3	%	33.3	%	34.3	%
Risk free interest rate	4.9	%	4.9	%	4.8	%
Expected dividends	2.4	%	2.4	%	2.3	%
Expected life in years	6.1		6.1		6.3	
Weighted average fair value	\$	11.48	\$	11.48	\$	12.40

As of September 30, 2006, there was \$0.3 million of total unrecognized compensation cost related to SARs that is expected to be recognized over a weighted-average period of 2.4 years.

The table below presents activity of SARs for the nine months ended September 30, 2006:

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value (in thousands)
Outstanding at January 1, 2006	34,685	\$ 1.72		
Changes during the year:				
Granted	31,547	10.80		
Forfeited	(10,071 )	2.67		
Outstanding at September 30, 2006	56,161	6.65	9.0	\$ 93
Vested and expected to vest at September 30, 2006	52,961	6.62	9.0	\$ 89
Exercisable at September 30, 2006				\$

**Pro Forma Disclosures**

The following table illustrates the effect on net income and net income per share as if the Company had applied the fair value recognition provisions of SFAS 123 to stock-based compensation during the three and nine months ended September 30, 2005:

(Dollars in thousands, except per share amounts)	Three Months Ended September 30, 2005		Nine Months Ended September 30, 2005	
Net income, as reported	\$	17,997	\$	53,104
Add: Stock-based compensation expense included in reported net income, net of related tax effects		11		29
Deduct: Total stock compensation expense determined under fair value based method for all awards, net of related tax effects		(183	)	(548
Pro forma net income	\$	17,825	\$	52,585
Earnings per share:				
Basic - as reported	\$	0.59	\$	1.78
Basic - pro forma	\$	0.58	\$	1.76
Diluted - as reported	\$	0.58	\$	1.75
Diluted - pro forma	\$	0.57	\$	1.73

For purposes of this pro forma disclosure, the value of the options was estimated using the Black-Scholes option pricing formula and amortized on a straight-line basis over the respective vesting periods of the awards, with forfeitures recognized as they occurred.

**4. EARNINGS PER SHARE**

The following table presents the information used to compute basic and diluted earnings per share for the periods indicated:

(In thousands, except per share data)	Three Months Ended September 30, 2006		September 30, 2005		Nine Months Ended September 30, 2006		2005	
Net income	\$	20,603	\$	17,997	\$	60,380	\$	53,104
Weighted average shares outstanding - basic		30,532		30,401		30,465		29,804
Dilutive effect of employee stock options and awards		306		435		325		462
Weighted average shares outstanding - diluted		30,838		30,836		30,790		30,266
Basic earnings per share	\$	0.67	\$	0.59	\$	1.98	\$	1.78
Diluted earnings per share	\$	0.67	\$	0.58	\$	1.96	\$	1.75

**5. MERGER WITH CB BANCSHARES, INC.**

The Company completed its merger with CB Bancshares, Inc. ( CBBI ) on September 15, 2004 (the Effective Date ). At the Effective Date, the Company recorded liabilities totaling \$17.6 million for estimated costs to exit certain CBBI facilities and operations. These liabilities, net of tax, were included in the cost of the merger, resulting in an increase in goodwill. Certain adjustments to the estimates have been recorded as adjustments to the cost of the merger.

The Company closed nine CBBI branch offices in February 2005 and vacated the former CBBI headquarters, consolidated certain operational functions with the Company's operations, and eliminated approximately 70 positions from the combined organization. These exit plans were finalized and completed in the third quarter of 2005.

The following table sets forth information related to the exit costs accrued, adjustments to estimates and payments made against accrued amounts:

(Dollars in thousands)	Balance as of December 31, 2005	Adjustments to estimates	Payments	Balance as of September 30, 2006
Severance	\$ 63	\$	\$ 63	\$
Lease termination fees	9,310	(1,026	) 2,509	5,775
Asset write-offs	983			983
Contract termination fees	388		21	367
Total	\$ 10,744	\$ (1,026	) \$ 2,593	\$ 7,125

**6. GOODWILL AND OTHER INTANGIBLE ASSETS**

At September 30, 2006, goodwill recorded in conjunction with the acquisitions of CBBI and Hawaii Home Loans, Inc. ( HHL ) totaled \$298.1 million, of which \$153.1 million was allocated to the Hawaii Market reporting segment and \$145.0 million was allocated to the Commercial Real Estate reporting segment.

Other intangible assets included a core deposit premium of \$32.9 million and \$37.4 million and mortgage servicing rights of \$11.8 million and \$11.8 million at September 30, 2006 and 2005, respectively. The gross carrying value and accumulated amortization related to the core deposit premium and mortgage servicing rights as of September 30, 2006 and 2005 are presented below:

(Dollars in thousands)	September 30, 2006		December 31, 2005		September 30, 2005	
	Gross Carrying Value	Accumulated Amortization	Gross Carrying Value	Accumulated Amortization	Gross Carrying Value	Accumulated Amortization
Core deposit premium	\$ 44,642	\$ 11,770	\$ 44,642	\$ 8,847	\$ 44,642	\$ 7,192
Mortgage servicing rights	18,705	6,911	17,051	5,231	17,111	5,263

The following table presents changes in goodwill and other intangible assets for the periods presented:

Edgar Filing: CENTRAL PACIFIC FINANCIAL CORP - Form 10-Q

(Dollars in thousands)	Three Months Ended September 30, 2006			September 30, 2005		
	Goodwill	Core Deposit Premium	Mortgage Servicing Rights	Goodwill	Core Deposit Premium	Mortgage Servicing Rights
Balance, beginning of period	\$ 297,251	\$ 33,846	\$ 11,873	\$ 288,090	\$ 39,105	\$ 3,470
Additions (deductions)	870		468	11,142		8,956
Amortization		(974 )	(547 )		(1,655 )	(578 )
Balance, end of period	\$ 298,121	\$ 32,872	\$ 11,794	\$ 299,232	\$ 37,450	\$ 11,848

(Dollars in thousands)	Nine Months Ended September 30, 2006			September 30, 2005		
	Goodwill	Core Deposit Premium	Mortgage Servicing Rights	Goodwill	Core Deposit Premium	Mortgage Servicing Rights
Balance, beginning of period	\$ 303,358	\$ 35,795	\$ 11,820	\$ 284,712	\$ 49,188	\$ 3,848
Additions (deductions)	(5,237 )		1,671	14,520	(7,127 )	9,151
Amortization		(2,923 )	(1,697 )		(4,611 )	(1,151 )
Balance, end of period	\$ 298,121	\$ 32,872	\$ 11,794	\$ 299,232	\$ 37,450	\$ 11,848

Goodwill at September 30, 2006 reflected a decrease of \$5.2 million from the balance reported as of December 31, 2005 due to adjustments related to CBBI income tax contingencies and subleases of CBBI leased properties. These decreases were partially offset by an earnout payment associated with the Company's fiscal 2005 acquisition of HHL.

Based on the core deposit premium and mortgage servicing rights held as of September 30, 2006, estimated amortization expense for the remainder of fiscal 2006, the next five succeeding fiscal years and all years thereafter are as follows:

(Dollars in thousands)	Estimated Amortization Expense	
	Core Deposit Premium	Mortgage Servicing Rights
2006 (remainder)	\$ 974	\$ 519
2007	2,739	1,889
2008	2,491	1,524
2009	2,491	1,184
2010	2,491	980
2011	2,491	816
Thereafter	19,195	4,882
	\$ 32,872	\$ 11,794



**7. LOANS**

Loans, excluding loans held for sale, consisted of the following at the dates indicated:

(Dollars in thousands)	September 30, 2006	December 31, 2005	September 30, 2005
Commercial, Financial and Agricultural	\$ 429,625	\$ 561,470	\$ 524,030
Real Estate:			
Construction	1,028,197	681,554	597,688
Mortgage-Commercial	1,177,995	1,276,564	1,267,388
Mortgage-Residential	909,784	796,015	758,295
Consumer	185,353	207,455	196,380
Leases	48,764	45,394	38,375
	3,779,718	3,568,452	3,382,156
Unearned income	14,637	15,703	15,536
	\$ 3,765,081	\$ 3,552,749	\$ 3,366,620

**8. ALLOWANCE FOR LOAN LOSSES**

The following table presents the changes in the allowance for loan losses for the periods indicated:

(Dollars in thousands)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Allowance for loan losses:				
Balance, beginning of period	\$ 52,914	\$ 51,657	\$ 52,936	\$ 50,703
Provision for loan losses	300	1,000	1,350	2,917
Charge-offs	(1,266 )	(1,341 )	(3,599 )	(4,751 )
Recoveries	663	1,429	1,924	3,876
Net (charge-offs) recoveries	(603 )	88	(1,675 )	(875 )
Balance, end of period	\$ 52,611	\$ 52,745	\$ 52,611	\$ 52,745

**9. ACCUMULATED OTHER COMPREHENSIVE LOSS**

Components of accumulated other comprehensive loss, net of taxes, is presented below:

(Dollars in thousands)	September 30, 2006	2005
Unrealized holding losses on available-for-sale investment securities	\$ (10,318 )	\$ (7,233 )
Pension liability adjustments	(6,440 )	(6,064 )
Balance, end of period	\$ (16,758 )	\$ (13,297 )

**10. PENSION PLANS**

Central Pacific Bank ( CPB ) has a defined benefit retirement plan (the Pension Plan ) which covers certain eligible employees. The plan was curtailed effective December 31, 2002, and accordingly, plan benefits were fixed as of that date.

The following table sets forth the components of net periodic benefit cost for the Pension Plan:

(Dollars in thousands)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Interest cost	\$ 385	\$ 399	\$ 1,155	\$ 1,197
Expected return on plan assets	(505 )	(475 )	(1,515 )	(1,425 )
Recognized net loss	226	216	678	648
Net periodic cost	\$ 106	\$ 140	\$ 318	\$ 420

CPB also established Supplemental Executive Retirement Plans ( SERPs ), which provide certain officers of CPB with supplemental retirement benefits.

The following table sets forth the components of net periodic benefit cost for the SERPs:

(Dollars in thousands)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Service cost	\$ 182	\$ 183	\$ 546	\$ 549
Interest cost	135	125	405	375
Amortization of unrecognized transition obligation	49	6	147	18
Recognized prior service cost	4	4	12	12
Recognized net gain	(12 )		(36 )	
Net periodic cost	\$ 358	\$ 318	\$ 1,074	\$ 954

## 11. SEGMENT INFORMATION

The Company has three reportable segments: Commercial Real Estate, Hawaii Market, and Treasury. The segments reported are consistent with internal functional reporting lines. They are managed separately because each unit has different target markets, technological requirements, marketing strategies and specialized skills. The Commercial Real Estate segment includes construction and real estate development lending in Hawaii, California and Washington. The Hawaii Market segment includes retail branch offices, commercial lending, residential mortgage lending and servicing, indirect auto lending, trust services and retail brokerage services. A full range of deposit and loan products and various other banking services are offered. The Treasury segment is responsible for managing the Company's investment securities portfolio and wholesale funding activities.

The All Others category includes activities such as electronic banking, data processing, and management of bank owned properties.

The accounting policies of the segments are consistent with the Company's accounting policies that are described in Note 1 to the consolidated financial statements in the Annual Report on Form 10-K for the year ended December 31, 2005 filed with the Securities and Exchange Commission. The majority of the Company's net income is derived from net interest income. Accordingly, Management focuses primarily on net interest income, rather than gross interest income and expense amounts, in evaluating segment profitability.

Intersegment net interest income (expense) was allocated to each segment based upon a funds transfer pricing process that assigns costs of funds to assets and earnings credits to liabilities based on market interest rates that reflect interest rate sensitivity and maturity characteristics. All administrative and overhead expenses are allocated to the segments at cost. Cash, investment securities, loans and their related balances are allocated to the segment responsible for acquisition and maintenance of those assets. Segment assets also include all premises and equipment used directly in segment operations.

Edgar Filing: CENTRAL PACIFIC FINANCIAL CORP - Form 10-Q

Segment profits and assets are provided in the following table for the periods indicated.

(Dollars in thousands)	Commercial Real Estate	Hawaii Market	Treasury	All Others	Total
<b>Three months September 30, 2006:</b>					
Net interest income	\$ 40,762	\$ 14,841	\$ (2,508 )	\$	\$ 53,095
Intersegment net interest income (expense)	(24,806 )	18,568	97	6,141	
Provision for loan losses	(16 )	316			300
Other operating income	93	8,371	1,635	446	10,545
Other operating expense	1,979	15,749	599	12,889	31,216
Administrative and overhead expense allocation	1,673	8,967	90	(10,730 )	
Income taxes	4,892	5,678	675	276	11,521
Net income (loss)	\$ 7,521	\$ 11,070	\$ (2,140 )	\$ 4,152	\$ 20,603
<b>Three months ended September 30, 2005:</b>					
Net interest income	\$ 28,033	\$ 19,975	\$ 1,566	\$	\$ 49,574
Intersegment net interest income (expense)	(15,310 )	14,646	(2,254 )	2,918	
Provision for loan losses	538	462			1,000
Other operating income	326	9,403	866	879	11,474
Other operating expense	2,075	14,196	755	15,315	32,341
Administrative and overhead expense allocation	1,708	10,119	201	(12,028 )	
Income taxes	3,409	6,312	543	(554 )	9,710
Net income (loss)	\$ 5,319	\$ 12,935	\$ (1,321 )	\$ 1,064	\$ 17,997
<b>Nine months ended September 30, 2006:</b>					
Net interest income	\$ 112,923	\$ 48,443	\$ (3,912 )	\$	\$ 157,454
Intersegment net interest income (expense)	(66,959 )	52,025	(2,455 )	17,389	
Provision for loan losses	71	1,279			1,350
Other operating income	289	27,060	4,557	1,763	33,669
Other operating expense	6,298	46,406	1,679	42,070	96,453
Administrative and overhead expense allocation	5,383	29,958	349	(35,690 )	
Income taxes	14,077	16,663	2,228	(28 )	32,940
Net income (loss)	\$ 20,424	\$ 33,222	\$ (6,066 )	\$ 12,800	\$ 60,380
<b>Nine months ended September 30, 2005:</b>					
Net interest income	\$ 82,260	\$ 56,666	\$ 5,478	\$	\$ 144,404
Intersegment net interest income (expense)	(41,783 )	42,958	(11,453 )	10,278	
Provision for loan losses	744	2,173			2,917
Other operating income	399	22,480	4,338	2,312	29,529
Other operating expense	5,373	42,841	1,941	41,809	91,964
Administrative and overhead expense allocation	4,488	26,900	647	(32,035 )	
Income taxes	10,351	16,382	991	(1,776 )	25,948
Net income (loss)	\$ 19,920	\$ 33,808	\$ (5,216 )	\$ 4,592	\$ 53,104
<b>At September 30, 2006:</b>					
Investment securities	\$	\$	\$ 899,173	\$	\$ 899,173
Loans (including loans held for sale)	1,970,853	1,815,970			3,786,823
Goodwill	144,968	153,153			298,121
Other	9,410	103,263	257,284	24,816	394,773
Total assets	\$ 2,125,231	\$ 2,072,386	\$ 1,156,457	\$ 24,816	\$ 5,378,890

Edgar Filing: CENTRAL PACIFIC FINANCIAL CORP - Form 10-Q

**At December 31, 2005:**

Investment securities	\$	\$	\$ 925,285	\$	\$ 925,285
Loans (including loans held for sale)	1,798,741	1,814,546			3,613,287
Goodwill	147,986	155,372			303,358
Other	7,020	101,888	253,922	34,379	397,209
<b>Total assets</b>	<b>\$ 1,953,747</b>	<b>\$ 2,071,806</b>	<b>\$ 1,179,207</b>	<b>\$ 34,379</b>	<b>\$ 5,239,139</b>

23

---

## Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

### Critical Accounting Policies

The preparation of financial statements in accordance with accounting principles generally accepted in the United States of America requires that management make certain judgments and use certain estimates and assumptions that affect amounts reported and disclosures made. Accounting estimates are deemed critical when a different estimate could have reasonably been used or where changes in the estimate are reasonably likely to occur from period to period and would materially impact our consolidated financial statements as of or for the periods presented. Management has discussed the development and selection of the critical accounting estimates noted below with the Audit Committee of the Board of Directors, and the Audit Committee has reviewed the accompanying disclosures.

*Allowance for Loan Losses.* We maintain the allowance for loan losses, or the Allowance, at an amount we expect to be sufficient to absorb probable losses inherent in our loan portfolio based on a projection of probable net loan charge-offs. For loans classified as impaired, an estimated impairment loss is calculated. To estimate net loan charge-offs on other loans, we evaluate the level and trend of nonperforming and potential problem loans and historical loss experience. We also consider other relevant economic conditions and borrower-specific risk characteristics, including current repayment patterns of our borrowers, the fair value of collateral securing specific loans, changes in our lending and underwriting standards and general economic factors, nationally and in the markets we serve. Estimated loss rates are determined by loan category and risk profile, and an overall required Allowance is calculated. Based on our estimate of the level of Allowance required, a provision for loan losses, or the Provision, is recorded to maintain the Allowance at an appropriate level. Since we cannot predict with certainty the amount of loan charge-offs that will be incurred, and because the eventual level of loan charge-offs are impacted by numerous conditions beyond our control, a range of loss estimates could reasonably have been used to determine the Allowance and Provision. In addition, various regulatory agencies, as an integral part of their examination processes, periodically review the Company's Allowance. Such agencies may require the Company to recognize additions to the Allowance based on their judgments about information available to them at the time of their examination. Accordingly, actual results could differ from those estimates.

*Goodwill and Other Intangible Assets.* We recorded goodwill and other intangible assets in connection with our acquisitions of CB Bancshares, Inc. and Hawaii HomeLoans, Inc., now known as Central Pacific HomeLoans, Inc. In accordance with SFAS No. 142, Goodwill and Other Intangible Assets, goodwill is not amortized but is to be reviewed at least annually for impairment, and when significant events occur or circumstances change which might cause an impairment of goodwill. An impairment loss is recorded when the carrying amount of goodwill exceeds the fair value of the goodwill. We perform an annual analysis of goodwill that involves the estimation of future cash flows and the fair value of reporting units to which goodwill is allocated. Our analysis indicated that there was no impairment of goodwill as of December 31, 2005. Since we cannot predict with certainty the future cash flows of individual reporting units, a

range of possible cash flows could have reasonably been used. Had we used cash flow assumptions that were materially lower than the estimates used, the analysis might have resulted in an impairment charge to earnings.

Other intangible assets include core deposit premiums and mortgage servicing rights, which are carried at the lower of amortized cost or fair value. Core deposit premiums are tested for recoverability whenever events or changes in circumstances indicate that its carrying amount may not be recoverable. For the three months ended June 30, 2006, we concluded that there were no events or changes in circumstances indicating that the carrying amount of the core deposit premium may not be recoverable. This conclusion was based on consideration of various factors including the level of market interest rates, legal factors, business climate and the performance of the deposits acquired relative to our expectations. Mortgage servicing rights are periodically assessed for impairment through an analysis that considers estimated future cash flows based on assumptions about loan prepayments, discount rates and various other factors. The assessment performed as of September 30, 2006 indicated no impairment of the value of mortgage servicing rights. Had we used assumptions that were materially different than those used in the analyses of core deposit premiums and mortgage servicing rights, those analyses might have resulted in an impairment charge to earnings.

*Deferred Tax Assets.* We account for income taxes in accordance with SFAS No. 109, Accounting for Income Taxes. Deferred taxes assets and liabilities are recognized for the estimated future tax effects attributable to temporary differences and carryforwards. A valuation allowance may be required if, based on the weight of available evidence, it is more likely than not that some portion or all of the deferred tax assets will not be realized. In determining whether a valuation allowance is necessary, we consider the level of taxable income in prior years, to the extent that carrybacks are permitted under current tax laws, as well as estimates of future taxable income and tax planning strategies that could be implemented to accelerate taxable income if necessary. If our estimates of future taxable income were materially overstated, or if our assumptions regarding the tax consequences of tax planning strategies were inaccurate, some or all of our deferred tax assets may not be realized, which would result in a charge to earnings.

*Defined Benefit Retirement Plan.* Defined benefit plan obligations and related assets of our defined benefit retirement plan are presented in Note 15 to the Consolidated Financial Statements for the year ended December 31, 2005 included in the Company's Annual Report on Form 10-K. Plan assets, which consist primarily of marketable equity and debt securities, are typically valued using market quotations. Plan obligations and the annual pension expense are determined by independent actuaries through the use of a number of assumptions. Key assumptions in measuring the plan obligations include the discount rate and the expected long-term rate of return on plan assets. In determining the discount rate, we utilize a yield that reflects the top 50% of the universe of bonds, ranked in the order of the highest yield. Asset returns are based upon the anticipated average rate of earnings expected on the invested funds of the plans. At December 31, 2005, we used a weighted-average discount rate of 5.69% and an expected long-term rate of return on plan assets of 8.00%, which affected the amount of pension liability recorded as of year-end 2005 and the amount of pension expense to be recorded in 2006. For both the discount rate and the asset return rate, a range of estimates could reasonably have been used which would

affect the amount of pension expense and pension liability recorded. A 0.25% change in the discount rate assumption would impact 2006 pension expense by \$41,000 and year-end 2005 pension liability by \$722,000, while a 0.25% change in the asset return rate would impact 2006 pension expense by \$64,000.

### Financial Summary

Net income for the third quarter of 2006 totaled \$20.6 million, or \$0.67 per diluted share, compared to \$18.0 million or \$0.58 per diluted share reported in the third quarter of 2005. Results for the third quarter of 2005 included nonrecurring merger-related expenses of \$2.1 million, net of tax, or \$0.07 per diluted share. The year-over-year increase in net income was driven largely by a 7.1% increase in net interest income.

Net income for the first nine months of 2006 of \$60.4 million increased by \$7.3 million or 13.7% over the same period in 2005. Results for the first quarter of 2006 included an after-tax charge of \$1.3 million, or \$0.04 per diluted share, in retirement expenses for a former senior executive, while 2005 results included nonrecurring merger-related expenses of \$3.3 million after tax. Increases in net interest income of 9.0% and other operating income of 14.0% contributed to the stronger earnings in 2006.

The following table presents annualized returns on average assets, average shareholders equity and average tangible equity and basic and diluted earnings per share for the periods indicated.

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Return on average assets	1.56	% 1.46	% 1.54	% 1.47
Return on average shareholders equity	11.52	% 10.79	% 11.50	% 11.06
Net income to average tangible equity	21.44	% 21.34	% 21.92	% 22.90
Basic earnings per share	\$ 0.67	\$ 0.59	\$ 1.98	\$ 1.78
Diluted earnings per share	\$ 0.67	\$ 0.58	\$ 1.96	\$ 1.75

### Material Trends

Hawaii's economy is expected to enjoy continued growth through year-end and into 2007, however, the growth is expected to be at a more measured pace than the past two years. Real gross state product is expected to increase by 2.7% in 2006 and by 2.4% in 2007, as compared to the 5.0% increase in 2004 and the 3.4% increase in 2005.(1) The moderation in expected growth is primarily

(1) Hawaii State Department of Business, Economic Development & Tourism.



the result of capacity constraints as evidenced by the state's low unemployment rate and high hotel occupancy rate.

While Hawaii visitor arrivals in 2006 are expected to increase 2.0% over the record total of 7.5 million visitors set in 2005, actual visitor arrivals for the first eight months of 2006 rose only 0.1% over the same period last year. However, an increase in average daily spending in 2006 resulted in a 4.5% increase in total visitor expenditures over the year ago period.(2)

On October 15, 2006, a large earthquake and a series of aftershocks shook the Hawaiian Islands. While federal, state and county officials are still in the process of assessing the full impact of the earthquake, we have no indications at this time of any significant damage or losses sustained by our customers or the properties that collateralize our loans. However, there can be no assurance that we will not incur increased loan losses or other adverse impacts as a result of earthquake damage or the related effects on our customers' personal and business interests.

Hawaii personal income is expected to increase 4.0% in 2006, following its 6.9% increase in 2005.(3) The state's unemployment rate, which is the lowest jobless rate in the nation, was 2.5% in September 2006, compared to 2.8% in September 2005.(4)

The Hawaii housing market continues to expand, however, unit sale growth rates have moderated and the listed inventory has increased over the past nine months. In September 2006, the number of single-family home resales on Oahu decreased by 19.9% while the median sales price increased by 0.8% from a year ago.(5)

California's economy has fully rebounded from the 2001 technology-related downturn. California is expected to enjoy continued moderate growth in 2006, but at a slower pace than in 2005.

California personal income is expected to increase 5.8% in 2006, following its 6.0% increase in 2005.(6) Reflecting the continued growth in the economy, California's unemployment rate has improved to 4.8% in September 2006 from 5.2% in September 2005.(7)

In September 2006, the number of single-family home resales in California decreased 31.7% while the median sales price increased 1.8% from a year ago.(8)

The Washington economy has also recovered from the 2001 technology-related downturn and is expected to post solid gains in 2006.

---

(2) Hawaii State Department of Business, Economic Development & Tourism.

(3) Ibid.

(4) Hawaii State Department of Labor and Industrial Relations.

(5) Honolulu Board of Realtors.

(6) California Department of Finance

(7) Bureau of Labor Statistics.

(8) California Association of Realtors.

Washington personal income is expected to increase 4.3% in 2006, following its 7.9% increase in 2005.(9) Washington's unemployment rate has improved to 5.3% in September 2006 from 5.6% in September 2005.(10)

During the second quarter of 2006, the number of Washington home resales declined 12.5% while the median sales price increased 14.9% from a year ago. (11)

Our results of operations over the remainder of 2006 may be directly impacted by the ability of the economies in Hawaii, California, Washington and other markets we serve to achieve their expected growth. Loan demand, deposit growth, provision for loan losses, noninterest income and noninterest expense may be affected by changes in economic conditions. If the economic environment in Hawaii, California, Washington or other markets we serve were to suffer an adverse change, such as a material decline in the real estate market or a material external shock, our results of operations may be negatively impacted.

---

(9) Washington State Economic and Revenue Forecast Council.

(10) Bureau of Labor Statistics.

(11) Washington Center for Real Estate Research.

28

---

**Results of Operations****Net Interest Income**

Net interest income, when expressed as a percentage of average interest earning assets, is referred to as net interest margin. A comparison of net interest income for the three and nine months ended September 30, 2006 and 2005 is set forth below.

(in thousands)	Three Months Ended September 30, 2006			Three Months Ended September 30, 2005		
	Average Balance	Average Yield/Rate	Interest	Average Balance	Average Yield/Rate	Interest
<b>Assets:</b>						
Interest earning assets:						
Interest-bearing deposits in other banks	\$ 6,537	4.83 %	\$ 79	\$ 5,176	2.86 %	\$ 37
Federal funds sold & securities purchased under agreements to resell	2,332	5.32 %	31	10,255	3.39 %	87
Investment securities(1)(2)	933,261	4.51 %	10,527	1,001,998	4.42 %	11,068
Loans, net of unearned income(3)	3,722,846	7.78 %	72,444	3,301,377	6.83 %	56,366
Federal Home Loan Bank stock	48,797			48,797		
Total interest earning assets	4,713,773	7.05 %	83,081	4,367,603	6.19 %	67,558
Nonearning assets	573,797			565,748		
Total assets	\$ 5,287,570			\$ 4,933,351		
<b>Liabilities &amp; Stockholders Equity:</b>						
Interest-bearing liabilities:						
Interest-bearing demand deposits	\$ 424,611	0.13 %	\$ 136	\$ 430,737	0.14 %	\$ 156
Savings and money market deposits	1,170,817	1.70 %	4,969	1,166,751	0.75 %	2,196
Time deposits under \$100,000	578,530	3.04 %	4,392	534,561	2.00 %	2,670
Time deposits \$100,000 and over	878,472	4.40 %	9,658	687,811	2.88 %	4,947
Short-term borrowings	85,843	5.69 %	1,221	29,804	4.28 %	319
Long-term debt	735,814	4.86 %	8,949	688,784	4.06 %	6,998
Total interest-bearing liabilities	3,874,087	3.03 %	29,325	3,538,448	1.95 %	17,286
Noninterest-bearing deposits	613,886			648,414		
Other liabilities	84,285			79,402		
Stockholders equity	715,312			667,087		
Total liabilities & stockholders equity	\$ 5,287,570			\$ 4,933,351		
Net interest income			\$ 53,756			\$ 50,272
Net interest margin		4.56 %			4.60 %	

Edgar Filing: CENTRAL PACIFIC FINANCIAL CORP - Form 10-Q

(in thousands)	Nine Months Ended September 30, 2006			Nine Months Ended September 30, 2005		
	Average Balance	Average Yield/Rate	Interest	Average Balance	Average Yield/Rate	Interest
<b>Assets:</b>						
Interest earning assets:						
Interest-bearing deposits in other banks	\$ 9,595	4.25	% \$ 306	\$ 13,677	2.36	% \$ 242
Federal funds sold & securities purchased under agreements to resell	2,384	4.75	% 85	7,795	2.84	% 166
Investment securities(1)(2)	936,062	4.58	% 32,140	929,040	4.40	% 30,654
Loans, net of unearned income(3)	3,651,835	7.47	% 204,603	3,237,027	6.65	% 161,338
Federal Home Loan Bank stock	48,797			48,733	0.74	% 272
Total interest earning assets	4,648,673	6.80	% 237,134	4,236,272	6.06	% 192,672
Nonearning assets	580,529			578,571		
Total assets	\$ 5,229,202			\$ 4,814,843		
<b>Liabilities &amp; Stockholders Equity:</b>						
Interest-bearing liabilities:						
Interest-bearing demand deposits	\$ 426,299	0.13	% \$ 428	\$ 429,238	0.18	% \$ 578
Savings and money market deposits	1,129,638	1.38	% 11,667	1,140,420	0.63	% 5,353
Time deposits under \$100,000	580,574	2.75	% 11,956	545,445	1.92	% 7,840
Time deposits \$100,000 and over	858,420	3.94	% 25,373	658,858	2.57	% 12,720
Short-term borrowings	51,302	5.29	% 2,035	52,550	2.94	% 1,159
Long-term debt	754,295	4.62	% 26,163	633,517	3.89	% 18,501
Total interest-bearing liabilities	3,800,528	2.72	% 77,622	3,460,028	1.78	% 46,151
Noninterest-bearing deposits	642,502			624,605		
Other liabilities	85,970			90,019		
Stockholders equity	700,202			640,191		
Total liabilities & stockholders equity	\$ 5,229,202			\$ 4,814,843		
Net interest income			\$ 159,512			\$ 146,521
Net interest margin		4.58	%		4.61	%

For the third quarter of 2006, net interest income on a taxable equivalent basis totaled \$53.8 million, increasing by 6.9% compared to the same period last year. Taxable-equivalent interest income for the third quarter of 2006 increased by \$15.5 million or 23.0% reflecting a \$16.1 million increase in interest and fees on loans on a \$421.5 million or 12.8% increase in average loans. The average yield on loans increased to 7.78% during the quarter from 6.83% in the year-ago-period, reflecting the increase in market interest rates during the period. Interest expense for the third quarter increased by \$12.0 million or 69.6% over the third quarter of 2005 reflecting higher market interest rates on deposits and other borrowings. Average interest-bearing deposits increased by \$232.6 million or 8.2%, and the average interest rate on those deposits increased by 110 basis points to 2.51%, resulting in a \$9.2 million increase in interest on deposits. Interest on long-term debt increased by \$2.0 million or 27.9% on a \$47.0 million increase in average balance and an 80 basis-point rise in average rate.

Net interest income on a taxable equivalent basis for the first nine months of 2006 totaled \$159.5 million, increasing by \$13.0 million or 8.9% over the comparable period in 2005. Taxable-equivalent interest income for the first nine months of 2006 increased by \$44.5 million

or 23.1% compared to the same period in 2005. Interest and fees on loans increased by \$43.3 million on a 12.8% increase in average loans and an 82 basis-point increase in average yield. Interest income for the first nine months of 2006 also reflected the recognition of \$0.7 million in interest income on the payoff of two nonaccrual loans in the first quarter of 2006. Interest expense for the first nine months of 2006 increased by \$31.5 million or 68.2% compared to the same period in 2005, reflecting the increase in market interest rates in 2005 and 2006. Interest expense on interest-bearing deposits increased by \$22.9 million due to an 8.0% increase in average balances and a 93 basis-point increase in average rates. Interest expense on long-term debt increased by \$7.7 million, reflecting a \$120.8 million increase in average balance and a 73 basis-point increase in average rate.

The net interest margin was 4.56% and 4.58% for the third quarter and first nine months of 2006, respectively, compared to 4.60% and 4.61%, respectively, for the comparable 2005 periods. The decline in the net interest margin reflects the shift of customer deposits from savings and money market accounts into higher-rate time deposits. We expect net interest margin in the range of 4.50% to 4.60% for the remainder of 2006, assuming we are able to achieve our growth targets and the current competitive pricing environment for loans and deposits does not change dramatically.

**Nonperforming Assets**

The following table sets forth nonperforming assets and accruing loans delinquent for 90 days or more at the dates indicated.

(Dollars in thousands)	September 30, 2006	December 31, 2005	September 30, 2005	
<b>Nonaccrual loans:</b>				
<b>Real estate:</b>				
Construction	\$	\$	\$	
Mortgage-commercial	2,636	4,223	3,390	
Mortgage-residential	5,030	5,995	6,198	
Commercial, financial and agricultural	358	2,333	4,456	
Consumer				
Total nonaccrual loans	8,024	12,551	14,044	
<b>Other real estate</b>				
Total nonperforming assets	8,024	12,551	14,044	
<b>Loans delinquent for 90 days or more:</b>				
<b>Real estate:</b>				
Construction	96			
Mortgage-commercial		7,081	9,724	
Mortgage-residential	2,272	297	163	
Commercial, financial and agricultural	22	99	62	
Consumer	419	427	250	
Leases		2		
Total loans delinquent for 90 days or more	2,809	7,906	10,199	
<b>Restructured loans still accruing interest:</b>				
<b>Real estate:</b>				
Mortgage-commercial		418	420	
Commercial, financial and agricultural		285	285	
Total restructured loans still accruing interest		703	705	
Total nonperforming assets, loans delinquent for 90 days or more and restructured loans still accruing interest	\$ 10,833	\$ 21,160	\$ 24,948	
Total nonperforming assets as a percentage of loans and other real estate	0.21	% 0.35	% 0.44	%
Total nonperforming assets and loans delinquent for 90 days or more as a percentage of loans and other real estate	0.29	% 0.57	% 0.75	%
Total nonperforming assets, loans delinquent for 90 days or more and restructured loans still accruing interest as a percentage of loans and other real estate	0.29	% 0.59	% 0.77	%

Nonperforming assets, accruing loans delinquent for 90 days or more and restructured loans still accruing interest totaled \$10.8 million at September 30, 2006, a decrease of 48.8% from the fiscal 2005 year-end balance of \$21.2 million and 56.6% from the year-ago balance of \$24.9 million. The decrease from year-end 2005 was primarily due to the payoff of a \$1.8 million nonaccrual commercial loan and a \$7.1 million delinquent commercial real estate loan in the first quarter of 2006 as well as a \$1.9 million nonaccrual commercial mortgage loan in the third quarter of 2006.

Nonaccrual loans totaled \$8.0 million as of September 30, 2006. Nonaccrual commercial mortgages at September 30, 2006 were comprised of a single \$2.6 million loan secured by a commercial office building on Oahu. Nonaccrual residential mortgage loans included one loan for \$4.8 million to a borrower who filed for bankruptcy protection in 2005. Both of these loans are well secured, with no loss anticipated at this time. We believe that the potential loss exposure on total nonaccrual loans has been adequately provided for in the allowance for loan and lease losses (the Allowance ) as of September 30, 2006.

There was no other real estate at September 30, 2006 and 2005, and December 31, 2005.

Accruing loans delinquent 90 days or more at September 30, 2006 totaled \$2.8 million, compared to \$7.9 million at year-end 2005 and \$10.2 million a year ago. The decline from year-end 2005 was primarily due to the payoff of the \$7.1 million commercial real estate loan in the first quarter of 2006.

There were no restructured loans still accruing interest at September 30, 2006 as the loans outstanding as of year-end 2005 and September 30, 2005 were paid in full in the third quarter of 2006.

As of September 30, 2006, there were 7 impaired loans to four borrowers totaling \$6.1 million, compared to 10 impaired loans to three borrowers totaling \$3.8 million a year ago, and 11 loans to six borrowers totaling \$18.9 million at year-end 2005. All impaired loans were comprised primarily of loans secured by commercial properties.

We continue to closely monitor loan delinquencies and impairments and to work with borrowers to resolve loan problems. Any deterioration in the economies of Hawaii, California or Washington may impact loan quality, and may result in increases in nonperforming assets, delinquencies and restructured loans.

#### ***Provision for Loan Losses***

A discussion of our accounting policy regarding the Allowance is contained in the Critical Accounting Policies section of this report.

Edgar Filing: CENTRAL PACIFIC FINANCIAL CORP - Form 10-Q

The following table sets forth certain information with respect to the Allowance as of the dates and for the periods indicated.

(Dollars in thousands)	Three Months Ended September 30,		Nine Months Ended September 30,		
	2006	2005	2006	2005	
<b>Allowance for loan losses:</b>					
Balance at beginning of period	\$ 52,914	\$ 51,657	\$ 52,936	\$ 50,703	
Provision for loan and lease losses	300	1,000	1,350	2,917	
<b>Loan charge-offs:</b>					
Commercial, financial and agricultural	127	136	496	1,086	
<b>Real estate:</b>					
Mortgage-commercial					
Mortgage-residential				74	
Consumer	1,138	810	3,084	2,960	
Leases	1	395	19	631	
Total loan charge-offs	1,266	1,341	3,599	4,751	
<b>Recoveries:</b>					
Commercial, financial and agricultural	112	465	229	1,366	
<b>Real estate:</b>					
<b>Construction</b>					
Mortgage-residential	37	187	79	554	
Mortgage-commercial	3	238	9	518	
Consumer	506	451	1,599	1,329	
Leases	5	88	8	109	
Total recoveries	663	1,429	1,924	3,876	
Net loan charge-offs (recoveries)	603	(88 )	1,675	875	
Balance at end of period	\$ 52,611	\$ 52,745	\$ 52,611	\$ 52,745	
Annualized ratio of net loan charge-offs (recoveries) to average loans	0.06	% -0.01	% 0.06	% 0.04	%

The provision for loan and lease losses (the Provision ) was \$0.3 million and \$1.4 million for the third quarter and first nine months of 2006, respectively, compared to \$1.0 million and \$2.9 million, respectively, for the comparable periods in 2005. The decrease in the Provision is reflective of the improvement in asset quality particularly in nonperforming assets and delinquencies.

The Allowance, expressed as a percentage of total loans, was 1.40% at September 30, 2006 compared to 1.49% at year-end 2005 and 1.57% at September 30, 2005. We believe that the Allowance is adequate to cover the credit risks inherent in the loan portfolio. Any economic deterioration in the areas we serve could adversely affect the borrowers ability to repay their



loans or the value of collateral securing those loans and, consequently, the level of net loan charge-offs and Provision.

Net loan charge-offs totaled \$0.6 million and \$1.7 million for the third quarter and first nine months of 2006, compared to net loan recoveries of \$0.1 million for the third quarter of 2005 and net loan charge-offs of \$0.9 million for the first nine months of 2005. When expressed as an annualized percentage of average loans, net loan charge-offs were 0.06% for the three and nine months ended September 30, 2006, respectively, compared to net loan recoveries of 0.01% and net loan charge-offs of 0.04%, respectively, for the same periods in 2005.

#### ***Other Operating Income***

Total other operating income of \$10.5 million for the third quarter of 2006 decreased by \$0.9 million or 8.1% from the same period last year largely due to a decline in mortgage banking revenue, including a \$0.3 million decline in loan placement fees and a \$0.9 million decline in gains on sales of loans. Mortgage origination activity slowed during the third quarter of 2006, reflecting a decline in real estate sales activity in Hawaii as well as a decline in mortgage refinancing activity. The decline in mortgage banking revenue was partially offset by income from bank-owned life insurance, which increased by \$0.6 million due to market value increases and additional insurance purchased in the first quarter of 2006.

For the nine months ended September 30, 2006, total other operating income of \$33.7 million increased by \$4.1 million or 14.0% over the same period last year. Service charges on deposits increased by \$2.3 million, income from bank-owned life insurance increased by \$1.1 million and gains on sales of loans increased by \$1.1 million during the period, partially offset by a decline in investment securities gains of \$1.4 million. The increase in gains on sales of loans reflects the increased residential mortgage lending activity attributed to the acquisition of Central Pacific HomeLoans, Inc. ( CPHL ) in the third quarter of 2005.

#### ***Other Operating Expense***

Total other operating expense was \$31.2 million for the third quarter of 2006, down \$1.1 million or 3.5% from the same period in 2005. Other operating expense for the third quarter of 2005 was impacted by \$3.5 million in nonrecurring merger-related expenses, including \$2.7 million in severance and retention expenses, reported in salaries and employee benefits, and \$0.8 million for an additional FDIC deposit insurance assessment, reported in other expense. Salaries and employee benefits for the third quarter of 2006 included the recognition of \$0.6 million in stock option expense and increased staffing costs from the CPHL acquisition. Core deposit premium amortization declined by \$0.7 million based on the use of a declining amortization schedule. During the third quarter of 2006, we revised our methodology for estimating loss reserves for unfunded loan commitments and off-balance sheet liabilities resulting in a \$0.8 million reduction in the reserve for unfunded commitments and a corresponding credit to other expense.

For the first nine months of 2006, total other operating expense of \$96.5 million increased by \$4.5 million or 4.9% over the same period last year. Salaries and employee benefits increased by

\$6.1 million, reflecting increased staffing expense from the CPHL acquisition and \$2.0 million in stock option expense. \$2.2 million in retirement benefits paid to a former executive officer were recognized in 2006, while \$3.8 million in merger-related severance and retention expenses were recorded in 2005. Amortization of core deposit premium declined by \$1.7 million, while other expense increased by \$0.5 million, due to interest accruing on various tax-related contingencies, offset by a \$0.5 million partial refund of an FDIC assessment and the previously-discussed \$0.8 million reduction in the reserve for unfunded commitments.

### ***Income Taxes***

The effective tax rate was 35.86% and 35.30% for the three and nine months ended September 30, 2006, respectively, compared to 35.05% and 32.82%, respectively, for the same periods in 2005. In the second quarter of 2006, we recognized a \$0.5 million tax benefit as a result of an Internal Revenue Service audit of the Company's 2002 fiscal year. In the first quarter of 2005, we recognized \$1.8 million in state tax credits from investments in high-technology businesses in Hawaii. We expect the effective tax rate to approximate 36% for the remainder of 2006. Factors that may affect the effective tax rate for the 2006 include the level of tax-exempt income recognized, the amount of nondeductible expenses incurred, the amount of tax credits available to offset future taxable income.

### **Financial Condition**

Total assets at September 30, 2006 grew to \$5.4 billion, increasing by \$139.8 million or 2.7% compared to year-end 2005 and by \$337.3 million or 6.7% from a year ago.

Loans, net of unearned income, grew to \$3.8 billion, increasing by \$212.3 million or 6.0% over year-end 2005 and by \$398.5 million or 11.8% compared to a year ago. The increase over year-end 2005 is attributable to construction loans, which increased by nearly \$350 million during the first nine months of 2006, and to residential mortgage loans, which increased by approximately \$100 million. These increases were partially offset by decreases in commercial loans of \$140 million and commercial mortgages of \$100 million during the first nine months of 2006. Our mainland loan production offices contributed approximately 85% of our total loan growth during the first nine months of 2006, while our Hawaii lending activity contributed 15% of our loan growth. During 2006, our Hawaii loan portfolio was impacted by higher than expected loan prepayments and the payoff of \$14.1 million in nonaccrual and delinquent loans. Based on current loan pipeline estimates, we expect loan origination activity to remain at or near current levels for the remainder of 2006.

Total deposits at September 30, 2006 of \$3.8 billion increased by \$139.7 million or 3.8% over year-end 2005 and \$311.1 million or 9.0% compared to a year ago.

Noninterest-bearing deposits decreased by \$122.7 million or 16.8% in the first nine months of 2006, while interest-bearing deposits increased by \$262.4 million or 9.0%. Compared to a year ago, noninterest-bearing deposits decreased by \$51.5 million or 7.8%, and interest-bearing deposits increased by \$362.6 million or 12.9%. The fluctuation in noninterest-bearing deposits is attributable in part to the transfer of approximately \$40 million in deposits from noninterest-bearing

accounts to interest-bearing accounts in the third quarter of 2006 in connection with a deposit product realignment. Seasonal fluctuations, particularly in commercial demand deposit accounts, and disintermediation into higher-rate deposit and investment sweep products also contributed to the decline in noninterest-bearing deposits during the year. To generate deposit growth in the competitive Hawaii market, we focus our sales efforts and marketing resources on our premier product, the Exceptional Checking and Savings accounts, which generated the increase in savings and money market balances during the period, supplemented by Free Checking and periodic certificate of deposit specials.

### Capital Resources

Shareholders' equity was \$722.9 million at September 30, 2006, compared to \$676.2 million at year-end 2005 and \$665.0 million a year ago. Book value per share at September 30, 2006 was \$23.58, compared to \$22.22 at year-end 2005 and \$21.87 a year ago.

On July 26, 2006, the board of directors declared a third quarter cash dividend of \$0.23 per share, an increase of 21.1% over the \$0.19 per share dividend declared in the third quarter of 2005 and an increase of 9.5% over the 2006 second quarter dividend of \$0.21 per share. For the first nine months of 2006, dividends declared totaled \$0.65 per share, an increase of 20.4% over the \$0.54 per share declared in the first nine months of 2005.

In April 2006, the board of directors approved a new stock repurchase program, authorizing the repurchase of up to 600,000 shares of the Company's common stock on the open market or in privately negotiated transactions from time to time prior to April 30, 2007. The repurchase plan represents approximately 2% of the Company's currently outstanding common stock. The new repurchase plan replaces the 2002 stock repurchase program. There were no repurchases of common stock in the first nine months of 2006.

We have five statutory trusts: CPB Capital Trust I, CPB Capital Trust II, CPB Statutory Trust III, CPB Capital Trust IV and CPB Statutory Trust V, which issued a total of \$105.0 million in trust preferred securities. The statutory trusts are not consolidated in the consolidated financial statements as of June 30, 2006. However, the Federal Reserve Board (the "FRB") has determined that certain cumulative preferred securities, such as the trust preferred securities issued by the capital and statutory trusts, qualify as minority interest, and are included in the calculation of Tier 1 capital up to 25% of total risk-based capital with the excess includable as Tier 2 capital.

Our objective with respect to capital resources is to maintain a level of capital that will support sustained asset growth and anticipated risks. Furthermore, we seek to ensure that regulatory guidelines and industry standards for well-capitalized institutions are met.

Regulations on capital adequacy guidelines adopted by the FRB and the Federal Deposit Insurance Corporation (the "FDIC") are as follows. An institution is required to maintain a minimum ratio of qualifying total capital to risk-adjusted assets of 8% and a minimum ratio of Tier 1 capital to risk-adjusted assets of 4%. In addition to the risk-based guidelines, federal banking regulators require banking organizations to maintain a minimum amount of Tier 1

capital to total assets, referred to as the leverage ratio. For a banking organization rated in the highest of the five categories used by regulators to rate banking organizations, the minimum leverage ratio of Tier 1 capital to total assets must be 3%. In addition to these uniform risk-based capital guidelines and leverage ratios that apply across the industry, the regulators have the discretion to set individual minimum capital requirements for specific institutions at rates significantly above the minimum guidelines and ratios.

The following table sets forth the Company's capital ratios and capital adequacy requirements applicable as of the dates indicated. In addition, FDIC-insured institutions such as our principal banking subsidiary, Central Pacific Bank, must maintain leverage, Tier 1 and total risk-based capital ratios of at least 5%, 6% and 10%, respectively, to be considered well capitalized under the prompt corrective action provisions of the FDIC Improvement Act of 1991.

(Dollars in thousands)	Actual Amount	Ratio	Minimum Required for Capital Adequacy Purposes Amount	Ratio	Minimum Required to be Well Capitalized Amount	Ratio
<b>Company</b>						
At September 30, 2006:						
Leverage capital	\$ 532,774	10.78	% \$ 197,755	4.00	% \$ 247,194	5.00 %
Tier 1 risk-based capital	532,774	11.85	179,885	4.00	269,827	6.00
Total risk-based capital	588,034	13.08	359,770	8.00	449,712	10.00
At December 31, 2005:						
Leverage capital	\$ 463,528	9.73	% \$ 190,486	4.00	% \$ 238,108	5.00 %
Tier 1 risk-based capital	463,528	10.36	178,984	4.00	268,477	6.00
Total risk-based capital	519,471	11.61	357,969	8.00	447,461	10.00
<b>Central Pacific Bank</b>						
At September 30, 2006:						
Leverage capital	\$ 506,799	10.17	% \$ 199,307	4.00	% \$ 249,134	5.00 %
Tier 1 risk-based capital	506,799	11.29	179,540	4.00	269,310	6.00
Total risk-based capital	562,059	12.52	359,080	8.00	448,850	10.00
At December 31, 2005:						
Leverage capital	\$ 423,544	8.98	% \$ 188,709	4.00	% \$ 235,886	5.00 %
Tier 1 risk-based capital	423,544	9.48	178,675	4.00	268,012	6.00
Total risk-based capital	479,391	10.73	357,349	8.00	446,687	10.00

### Liquidity

Our objective in managing liquidity is to maintain a balance between sources and uses of funds in order to economically meet the cash requirements of customers for loans and deposit

withdrawals and participate in lending and investment opportunities as they arise. We monitor our liquidity position in relation to trends of loan demand and deposit growth on a daily basis to assure maximum utilization, maintenance of an adequate level of readily marketable assets and access to short-term funding sources.

During the first nine months of 2006, loan growth exceeded deposit growth and was funded from a variety of sources, including proceeds from maturities of investment securities and increases in deposits.

We anticipate that loan demand will continue to exceed deposit growth for the remainder of 2006. Liquidity needs due to excess loan growth is expected to be satisfied by cash flows generated by investment securities maturities and secondary funding sources, such as the Federal Home Loan Bank of Seattle ( FHLB ). Central Pacific Bank is a member of, and maintained a \$1.3 billion line of credit with, the FHLB as of September 30, 2006, of which \$663.3 million was outstanding. We believe that our current sources of funding are adequate to meet our liquidity needs for the near term.

39

---

**Item 3. Quantitative and Qualitative Disclosures About Market Risk**

Market risk is the risk of loss in a financial instrument arising from adverse changes in market rates/prices such as interest rates, foreign currency rates, commodity prices and equity prices. Our primary market risk exposure is interest rate risk that occurs when rate-sensitive assets and rate-sensitive liabilities mature or reprice during different periods or in differing amounts. Asset/liability management attempts to coordinate our rate-sensitive assets and rate-sensitive liabilities to meet our financial objectives. The Asset/Liability Committee ( ALCO ) monitors interest rate risk through the use of interest rate sensitivity gap, net interest income and market value of portfolio equity simulation and rate shock analyses. Adverse interest rate risk exposures are managed through the shortening or lengthening of the duration of assets and liabilities.

The primary analytical tool we use to measure and manage our interest rate risk is a simulation model that projects changes in net interest income ( NII ) as market interest rates change. Our ALCO policy requires that simulated changes in NII should be within certain specified ranges, or steps must be taken to reduce interest rate risk. The results of the model indicate that the mix of rate-sensitive assets and liabilities at September 30, 2006 would not result in a fluctuation of NII that would exceed the established policy limits.

**Item 4. Controls and Procedures**

**Evaluation of Disclosure Controls and Procedures**

As of the end of the period covered by this report and pursuant to Rule 13a-15 of the Securities Exchange Act of 1934, as amended, (the Exchange Act ), the Company s Management, including the Chief Executive Officer and Principal Financial and Accounting Officer, conducted an evaluation of the effectiveness and design of the Company s disclosure controls and procedures (as that term is defined in Rules 13a-15(e) and 15d-15(e) of the Exchange Act). Based upon that evaluation, the Company s Chief Executive Officer and Principal Financial and Accounting Officer concluded, as of the end of the period covered by this report, that the Company s disclosure controls and procedures were effective in recording, processing, summarizing and reporting information required to be disclosed by the Company, within the time periods specified in the Securities and Exchange Commission s rules and forms.

**Changes in Internal Controls**

As of the end of the period covered by this report, there have been no changes in the Company s internal control over financial reporting (as defined in Rule 13a-15(f) and 15d-15(f) of the Exchange Act) during the quarter to which this report relates that have materially affected or is reasonably likely to materially affect, the internal control over financial reporting.

**PART II. OTHER INFORMATION**

**Item 1. Legal Proceedings**

We are involved from time to time in various claims, disputes and other legal actions in the ordinary course of business. We believe that the resolution of such additional matters will not have an adverse material effect upon our financial position or results of operations when resolved.

**Item 1A. Risk Factors**

There have been no material changes from Risk Factors as previously disclosed in our Annual Report on Form 10-K for the period ended December 31, 2005, filed with the SEC.

**Item 2. Unregistered Sales of Equity and Use of Proceeds**

None.

**Item 3. Defaults Upon Senior Securities**

None.

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

None.

**Item 5. Other Information**

None.

**Item 6. Exhibits**

<b>Exhibit No.</b>	<b>Document</b>
3.1	Restated Articles of Incorporation of the Registrant (1)
3.2	Bylaws of the Registrant, as amended (2)
4.1	Rights Agreement dated as of August 26, 1998 between Registrant and the Rights Agent (3)
10.1	License and Service Agreement dated July 30, 1997 by and between the Registrant and Fiserv Solutions, Inc. (4)
10.2	Split Dollar Life Insurance Plan (5)(15)
10.3	Central Pacific Bank Supplemental Executive Retirement Plan (6)(15)

<b>Exhibit No.</b>	<b>Document</b>
10.4	The Registrant's 1997 Stock Option Plan, as amended (6)(15)
10.5	The Registrant's Directors' Deferred Compensation Plan (7)(15)
10.6	The Registrant's 2004 Stock Compensation Plan (8)(15)
10.7	Supplemental Retirement Agreement dated February 28, 2002 by and between Central Pacific Bank and Naoaki Shibuya (9)(15)
10.8	Supplemental Retirement Agreement dated June 28, 2002 by and between Central Pacific Bank and Joichi Saito (10)(15)
10.9	Employment Agreement, effective as of September 14, 2004, by and between the Registrant and Clinton L. Arnoldus (11)(15)
10.10	Employment Agreement, effective as of September 14, 2004, by and between the Registrant and Ronald K. Migita (11)(15)
10.11	Employment Agreement, effective as of September 14, 2004, by and between the Registrant and Neal K. Kanda (11)(15)
10.12	Employment Agreement, effective as of September 14, 2004, by and between the Registrant and Blenn A. Fujimoto (11)(15)
10.13	Employment Agreement, effective as of September 14, 2004, by and between the Registrant and Denis K. Isono (11)(15)
10.14	Employment Agreement, effective as of September 14, 2004, by and between the Registrant and Dean K. Hirata (12)(15)
10.15	Form of Restricted Stock Award Agreement (8)(15)
10.16	Supplemental Executive Retirement Agreement for Blenn A. Fujimoto, effective July 1, 2005 (13)(15)
10.17	Supplemental Executive Retirement Agreement for Dean K. Hirata, effective July 1, 2005 (13)(15)
10.18	Retirement Agreement of Neal K. Kanda dated February 22, 2006 (14) (15)
10.19	The Registrant's Long-Term Executive Incentive Plan (15) (16)
14.1	The Registrant's Code of Conduct and Ethics (17)
14.2	The Registrant's Code of Conduct and Ethics for Senior Financial Officers (18)



<b>Exhibit No.</b>	<b>Document</b>
31.1	Rule 13a-14(a) Certification of Chief Executive Officer in accordance with Section 302 of the Sarbanes-Oxley Act of 2002 *
31.2	Rule 13a-14(a) Certification of Chief Financial Officer in accordance with Section 302 of the Sarbanes-Oxley Act of 2002 *
32.1	Section 1350 Certification of Chief Executive Officer in accordance with Section 906 of the Sarbanes-Oxley Act of 2002 **
32.2	Section 1350 Certification of Chief Financial Officer in accordance with Section 906 of the Sarbanes-Oxley Act of 2002 **

---

Edgar Filing: CENTRAL PACIFIC FINANCIAL CORP - Form 10-Q

\* Filed herewith.

\*\* Furnished herewith.

- (1) Filed as Exhibit 3.1 to the Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2005, filed with the Securities and Exchange Commission on August 9, 2005.
- (2) Filed as Exhibit 3.2 to the Registrant's Current Report on Form 8-K, filed with the Securities and Exchange Commission on October 31, 2006.
- (3) Filed as Exhibit 4.1 to the Registrant's Registration Statement on Form 8-A, filed with the Securities and Exchange Commission on September 16, 1998.
- (4) Filed as Exhibit 10.11 to the Registrant's Annual Report on Form 10-K for the fiscal year ended December 31, 1998, filed with the Securities and Exchange Commission on March 30, 1999.
- (5) Filed as Exhibit 10.16 to the Registrant's Annual Report on Form 10-K for the fiscal year ended December 31, 1991, filed with the Securities and Exchange Commission on March 27, 1992.
- (6) Filed as Exhibits 10.8 and 10.9 to the Registrant's Annual Report on Form 10-K for the fiscal year ended December 31, 1996, filed with the Securities and Exchange Commission on March 28, 1997.
- (7) Filed as Exhibit 10.12 to the Registrant's Annual Report on Form 10-K for the fiscal year ended December 31, 2000, filed with the Securities and Exchange Commission on March 30, 2001.
- (8) Filed as Exhibits 10.8 and 10.20 to the Registrant's Annual Report on Form 10-K for the fiscal year ended December 31, 2004, filed with the Securities and Exchange Commission on March 16, 2005.
- (9) Filed as Exhibit 10 to the Registrant's Quarterly Report on Form 10-Q for the quarter ended March 31, 2002, filed with the Securities and Exchange Commission on May 10, 2002.
- (10) Filed as Exhibit 10.13 to the Registrant's Annual Report on Form 10-K for the fiscal year ended December 31, 2002, filed with the Securities and Exchange Commission on March 14, 2003.
- (11) Filed as Exhibits 10.3, 10.4, 10.5, 10.7 and 10.8 to the Registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 2004, filed with the Securities and Exchange Commission on November 9, 2004.

43

---

- (12) Filed as Exhibit 10.9 to Amendment No. 1 to the Registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 2004, filed with the Securities and Exchange Commission on December 13, 2004.
- (13) Filed as Exhibits 99.1 and 99.2 to the Registrant's Current Report on Form 8-K, filed with the Securities and Exchange Commission on January 31, 2006.
- (14) Filed as Exhibit 99.1 to the Registrant's Current Report on Form 8-K, filed with the Securities and Exchange Commission on February 24, 2006.
- (15) Denotes management contract or compensation plan or arrangement.
- (16) Filed as Exhibit 10.19 to the Registrant's Annual Report on Form 10-K for the fiscal year ended December 31, 2005, filed with the Securities and Exchange Commission on March 15, 2006.
- (17) Filed as Exhibit 14.1 to the Registrant's Annual Report on Form 10-K for the fiscal year ended December 31, 2005, filed with the Securities and Exchange Commission on March 15, 2006.
- (18) Filed as Exhibit 14.2 to the Registrant's Annual Report on Form 10-K for the fiscal year ended December 31, 2005, filed with the Securities and Exchange Commission on March 15, 2006.

SIGNATURES

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

CENTRAL PACIFIC FINANCIAL CORP.  
(Registrant)

Date: November 8, 2006

/s/ Clint Arnoldus  
Clint Arnoldus  
Chief Executive Officer and President

Date: November 8, 2006

/s/ Dean K. Hirata  
Dean K. Hirata  
Vice Chairman and  
Chief Financial Officer

Central Pacific Financial Corp.

Exhibit Index

<b>Exhibit No.</b>	<b>Description</b>
31.1	Certification of the Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Certification of the Principal Financial and Accounting Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Certification of the Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2	Certification of the Principal Financial and Accounting Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

45

---