

CENTRAL PACIFIC FINANCIAL CORP  
Form 10-Q  
August 09, 2012  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington D.C. 20549

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**FORM 10-Q**

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(Mark One)

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

For the quarterly period ended June 30, 2012

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 001-31567

## CENTRAL PACIFIC FINANCIAL CORP.

(Exact name of registrant as specified in its charter)

**Hawaii**  
(State or other jurisdiction of  
incorporation or organization)

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

**220 South King Street, Honolulu, Hawaii 96813**

(Address of principal executive offices) (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 has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). 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

Smaller reporting company

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

The number of shares outstanding of registrant's common stock, no par value, on August 1, 2012 was 41,868,600 shares.

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**PART I. FINANCIAL INFORMATION**

**Forward-Looking Statements**

This document may contain forward-looking statements concerning projections of revenues, income/loss, earnings/loss 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, hopes, should, estimates 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 forward-looking statements for a variety of reasons, to include, but not limited to: the effect of, and our failure to comply with all of the requirements of, the Memorandum of Understanding with the Federal Deposit Insurance Corporation ( FDIC ) and the Hawaii Division of Financial Institutions ( DFI ), effective May 5, 2011, the Written Agreement with the Federal Reserve Bank of San Francisco ( FRBSF ) and DFI, dated July 2, 2010, and any further regulatory orders or regulatory agreements we may become subject to; our ability to continue making progress on our recovery plan; oversupply of inventory and adverse conditions in the Hawaii and California real estate markets and recurring weakness in the construction industry; adverse changes in the financial performance and/or condition of our borrowers and, as a result, increased loan delinquency rates, further deterioration in asset quality and further losses in our loan portfolio; our ability to utilize all or part of our deferred tax assets; the impact of local, national, and international economies and events (including natural disasters such as wildfires, tsunamis and earthquakes) on the Company's business and operations and on tourism, the military, and other major industries operating within the Hawaii market and any other markets in which the Company does business; the impact of the European debt crisis; deterioration or malaise in economic conditions, including the continued destabilizing factors in the financial industry and deterioration of the real estate market, as well as the impact of declining levels of consumer and business confidence in the state of the economy in general and in financial institutions in particular; changes in estimates of future reserve requirements based upon the periodic review thereof under relevant regulatory and accounting requirements; the impact of the Dodd-Frank Wall Street Reform and Consumer Protection Act, other regulatory reform, including but not limited to government-sponsored enterprise reform, and any related rules and regulations on our business operations and competitiveness; the costs and effects of legal and regulatory developments, including the resolution of legal proceedings or regulatory or other governmental inquiries and the results of regulatory examinations or reviews; the effects of and changes in trade, monetary and fiscal policies and laws, including the interest rate policies of the Board of Governors of the Federal Reserve System; inflation, interest rate, securities market and monetary fluctuations; negative trends in our market capitalization and adverse changes in the price of the Company's common shares; political instability; acts of war or terrorism; changes in consumer spending, borrowings and savings habits; technological changes; changes in the competitive environment among financial holding companies and other financial service providers; the effect of changes in accounting policies and practices, as may be adopted by the regulatory agencies, as well as the Public Company Accounting Oversight Board, the Financial Accounting Standards Board and other accounting standard setters; our ability to attract and retain skilled employees; changes in our organization, compensation and benefit plans; and our success at managing the risks involved in the foregoing items. 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 and, in particular, the discussion of Risk Factors set forth therein, and the Company's Form 10-Q for the last fiscal quarter. The Company does not update any of its forward-looking statements except as required by law.

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## CENTRAL PACIFIC FINANCIAL CORP. AND SUBSIDIARIES

## CONSOLIDATED BALANCE SHEETS

(Unaudited)

| (Amounts in thousands, except share data)  | June 30,<br>2012 | December 31,<br>2011 |
|--|------------------|----------------------|
| <b>Assets</b>  |                  |                      |
| Cash and due from banks  | \$ 72,967        | \$ 76,233            |
| Interest-bearing deposits in other banks   | 100,544          | 180,839              |
| Investment securities:   |                  |                      |
| Available for sale, at fair value  | 1,632,524        | 1,492,994            |
| Held to maturity (fair value of \$495 at June 30, 2012 and \$976 at December 31, 2011)   | 487              | 931                  |
| Total investment securities  | 1,633,011        | 1,493,925            |
| Loans held for sale  | 30,831           | 50,290               |
| Loans and leases   | 2,101,163        | 2,064,447            |
| Less allowance for loan and lease losses   | 103,814          | 122,093              |
| Net loans and leases   | 1,997,349        | 1,942,354            |
| Premises and equipment, net  | 50,195           | 51,414               |
| Accrued interest receivable  | 12,596           | 11,674               |
| Investment in unconsolidated subsidiaries  | 11,538           | 12,697               |
| Other real estate  | 49,379           | 61,681               |
| Other intangible assets  | 39,700           | 41,986               |
| Bank-owned life insurance  | 145,940          | 144,474              |
| Federal Home Loan Bank stock   | 48,797           | 48,797               |
| Other assets   | 34,223           | 16,501               |
| Total assets   | \$ 4,227,070     | \$ 4,132,865         |
| <b>Liabilities and Equity</b>  |                  |                      |
| Deposits:  |                  |                      |
| Noninterest-bearing demand   | \$ 769,010       | \$ 729,149           |
| Interest-bearing demand  | 626,613          | 569,371              |
| Savings and money market   | 1,161,066        | 1,136,180            |
| Time   | 1,005,628        | 1,008,828            |
| Total deposits   | 3,562,317        | 3,443,528            |
| Short-term borrowings  |                  | 34                   |
| Long-term debt   | 108,289          | 158,298              |
| Other liabilities  | 65,982           | 64,585               |
| Total liabilities  | 3,736,588        | 3,666,445            |
| Equity:  |                  |                      |
| Common stock, no par value, authorized 185,000,000 shares, issued and outstanding<br>41,867,892 and 41,749,116 shares at June 30, 2012 and December 31, 2011, respectively | 784,512          | 784,539              |
| Surplus  | 67,933           | 66,585               |
| Accumulated deficit  | (372,558)        | (396,848)            |
| Accumulated other comprehensive income   | 626              | 2,164                |
| Total shareholders' equity   | 480,513          | 456,440              |
| Non-controlling interest   | 9,969            | 9,980                |

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|                              |    |           |    |           |
|------------------------------|----|-----------|----|-----------|
| Total equity                 |    | 490,482   |    | 466,420   |
| Total liabilities and equity | \$ | 4,227,070 | \$ | 4,132,865 |

*See accompanying notes to consolidated financial statements.*

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## CENTRAL PACIFIC FINANCIAL CORP. AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF INCOME

(Unaudited)

| (Amounts in thousands, except per share data)                 | Three Months Ended<br>June 30, |           | Six Months Ended<br>June 30, |           |
|---|--------------------------------|-----------|------------------------------|-----------|
|   | 2012                           | 2011      | 2012                         | 2011      |
| <b>Interest income:</b>                                       |                                |           |                              |           |
| Interest and fees on loans and leases                         | \$ 24,393                      | \$ 26,464 | \$ 49,401                    | \$ 55,030 |
| <b>Interest and dividends on investment securities:</b>       |                                |           |                              |           |
| Taxable interest  | 7,589                          | 7,241     | 15,203                       | 12,462    |
| Tax-exempt interest   | 446                            | 179       | 643                          | 363       |
| Dividends   | 4                              |           | 7                            | 3         |
| Interest on deposits in other banks                           | 47                             | 300       | 128                          | 689       |
| Total interest income   | 32,479                         | 34,184    | 65,382                       | 68,547    |
| <b>Interest expense:</b>                                      |                                |           |                              |           |
| <b>Interest on deposits:</b>                                  |                                |           |                              |           |
| Demand  | 89                             | 161       | 175                          | 293       |
| Savings and money market                                      | 252                            | 500       | 551                          | 1,232     |
| Time  | 962                            | 1,902     | 2,035                        | 4,279     |
| Interest on short-term borrowings                             |                                |           |                              | 204       |
| Interest on long-term debt                                    | 917                            | 2,642     | 1,860                        | 5,359     |
| Total interest expense  | 2,220                          | 5,205     | 4,621                        | 11,367    |
| Net interest income   | 30,259                         | 28,979    | 60,761                       | 57,180    |
| Provision (credit) for loan and lease losses                  | (6,630)                        | (8,784)   | (11,620)                     | (10,359)  |
| Net interest income after provision for loan and lease losses | 36,889                         | 37,763    | 72,381                       | 67,539    |
| <b>Other operating income:</b>                                |                                |           |                              |           |
| Service charges on deposit accounts                           | 2,273                          | 2,449     | 4,589                        | 5,063     |
| Other service charges and fees                                | 4,156                          | 4,444     | 8,577                        | 8,502     |
| Income from fiduciary activities                              | 642                            | 739       | 1,268                        | 1,500     |
| Equity in earnings of unconsolidated subsidiaries             | 169                            | 38        | 215                          | 165       |
| Fees on foreign exchange                                      | 192                            | 149       | 282                          | 286       |
| Investment securities gains                                   |                                | 261       |                              | 261       |
| Loan placement fees   | 193                            | 82        | 433                          | 184       |
| Net gain on sales of residential loans                        | 3,394                          | 1,005     | 6,371                        | 3,203     |
| Income from bank-owned life insurance                         | 942                            | 980       | 1,533                        | 2,170     |
| Other   | 1,653                          | 790       | 3,578                        | 2,103     |
| Total other operating income                                  | 13,614                         | 10,937    | 26,846                       | 23,437    |
| <b>Other operating expense:</b>                               |                                |           |                              |           |
| Salaries and employee benefits                                | 17,629                         | 15,442    | 34,255                       | 30,475    |
| Net occupancy   | 3,264                          | 3,410     | 6,530                        | 6,768     |
| Equipment   | 1,021                          | 1,154     | 1,978                        | 2,284     |
| Amortization and impairment of other intangible assets        | 3,031                          | 1,629     | 4,792                        | 3,176     |
| Communication expense   | 816                            | 922       | 1,670                        | 1,803     |
| Legal and professional services                               | 3,806                          | 4,023     | 7,863                        | 6,740     |



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|  |           |          |           |           |
|--|-----------|----------|-----------|-----------|
| Computer software expense  | 958       | 929      | 1,893     | 1,812     |
| Advertising expense  | 857       | 830      | 1,726     | 1,666     |
| Foreclosed asset expense   | 2,602     | (1,222)  | 2,495     | 763       |
| Write down of assets   |           | 3,090    | 1,759     | 4,655     |
| Other  | 5,707     | 10,282   | 9,976     | 17,984    |
| Total other operating expense  | 39,691    | 40,489   | 74,937    | 78,126    |
| Income before income taxes   | 10,812    | 8,211    | 24,290    | 12,850    |
| Income tax expense   |           |          |           |           |
| Net income   | 10,812    | 8,211    | 24,290    | 12,850    |
| Preferred stock dividends, accretion of discount and conversion of preferred stock to common stock |           |          |           | (83,897)  |
| Net income available to common shareholders  | \$ 10,812 | \$ 8,211 | \$ 24,290 | \$ 96,747 |
| Per common share data:   |           |          |           |           |
| Basic earnings per share   | \$ 0.26   | \$ 0.20  | \$ 0.58   | \$ 3.22   |
| Diluted earnings per share   | 0.26      | 0.20     | 0.58      | 3.15      |
| Shares used in computation:  |           |          |           |           |
| Basic shares   | 41,717    | 40,700   | 41,674    | 30,059    |
| Diluted shares   | 41,959    | 41,078   | 41,959    | 30,733    |

*See accompanying notes to consolidated financial statements.*

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

|  | Three Months Ended<br>June 30, |           | Six Months Ended<br>June 30, |           |
|--|--------------------------------|-----------|------------------------------|-----------|
|  | 2012                           | 2011      | 2012                         | 2011      |
|  | (Dollars in thousands)         |           |                              |           |
| Net income   | \$ 10,812                      | \$ 8,211  | \$ 24,290                    | \$ 12,850 |
| Other comprehensive income (loss), net of tax          |                                |           |                              |           |
| Net change in unrealized gain on investment securities | 1,696                          | 10,177    | (1,784)                      | 11,168    |
| Net change in unrealized loss on derivatives           | (359)                          | (802)     | (931)                        | (1,918)   |
| Minimum pension liability adjustment                   | 588                            | 554       | 1,177                        | 1,109     |
| Other comprehensive income (loss), net of tax          | 1,925                          | 9,929     | (1,538)                      | 10,359    |
| Comprehensive income                                   | \$ 12,737                      | \$ 18,140 | \$ 22,752                    | \$ 23,209 |

*See accompanying notes to consolidated financial statements.*

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## CENTRAL PACIFIC FINANCIAL CORP. AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

|   | Six Months Ended<br>June 30, |            |
|---|------------------------------|------------|
|   | 2012                         | 2011       |
|   | (Dollars in thousands)       |            |
| Cash flows from operating activities:   |                              |            |
| Net income  | \$ 24,290                    | \$ 12,850  |
| Adjustments to reconcile net income to net cash provided by operating activities: |                              |            |
| Provision (credit) for loan and lease losses                                      | (11,620)                     | (10,359)   |
| Depreciation and amortization   | 3,120                        | 3,472      |
| Write down of assets  | 1,759                        | 4,655      |
| Write down of other real estate, net of gain on sale                              | 1,416                        | (1,599)    |
| Amortization and impairment of other intangible assets                            | 4,792                        | 3,176      |
| Net amortization of investment securities   | 7,304                        | 3,137      |
| Share-based compensation  | 1,348                        | 1,042      |
| Net gain on investment securities   |                              | (261)      |
| Net gain on sales of residential loans  | (6,371)                      | (3,203)    |
| Proceeds from sales of loans held for sale  | 411,200                      | 307,958    |
| Originations of loans held for sale   | (387,400)                    | (292,597)  |
| Equity in earnings of unconsolidated subsidiaries                                 | (215)                        | (165)      |
| Increase in cash surrender value of bank-owned life insurance                     | (3,462)                      | (842)      |
| Net change in other assets and liabilities  | (18,064)                     | 467        |
| Net cash provided by operating activities   | 28,097                       | 27,731     |
| Cash flows from investing activities:   |                              |            |
| Proceeds from maturities of and calls on investment securities available for sale | 170,511                      | 182,915    |
| Proceeds from sales of investment securities available for sale                   | 2,695                        | 5,324      |
| Purchases of investment securities available for sale                             | (321,821)                    | (877,800)  |
| Proceeds from maturities of and calls on investment securities held to maturity   | 441                          | 1,240      |
| Net loan principal repayments (loan originations)                                 | (45,839)                     | 102,598    |
| Proceeds from sales of loans originated for investment                            | 782                          | 26,721     |
| Proceeds from sale of other real estate   | 12,848                       | 24,724     |
| Proceeds from bank-owned life insurance   | 1,446                        | 158        |
| Purchases of premises and equipment   | (1,901)                      | (784)      |
| Distributions from unconsolidated subsidiaries                                    | 434                          | 523        |
| Net cash used in investing activities   | (180,404)                    | (534,381)  |
| Cash flows from financing activities:   |                              |            |
| Net increase in deposits  | 118,789                      | 97,373     |
| Repayments of long-term debt  | (50,009)                     | (50,441)   |
| Net decrease in short-term borrowings   | (34)                         | (201,095)  |
| Net proceeds from issuance of common stock and stock option exercises             |                              | 323,537    |
| Net cash provided by financing activities   | 68,746                       | 169,374    |
| Net decrease in cash and cash equivalents   | (83,561)                     | (337,276)  |
| Cash and cash equivalents at beginning of period                                  | 257,072                      | 790,739    |
| Cash and cash equivalents at end of period  | \$ 173,511                   | \$ 453,463 |

Supplemental disclosure of cash flow information:

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|  |    |       |           |
|--|----|-------|-----------|
| Cash paid during the period for:   |    |       |           |
| Interest   | \$ | 3,228 | \$ 11,543 |
| Income taxes   |    | 1     | 8         |
| Cash received during the period for:   |    |       |           |
| Income taxes   |    | 11    |           |
| Supplemental disclosure of noncash investing and financing activities:           |    |       |           |
| Net change in common stock held by directors deferred compensation plan          | \$ | 27    | \$ (16)   |
| Net reclassification of loans to other real estate                               |    | 1,962 | 8,481     |
| Net transfer of loans to loans held for sale                                     |    | 290   | 1,256     |
| Dividends accrued on preferred stock   |    |       | 969       |
| Accretion of preferred stock discount  |    |       | 204       |
| Preferred stock and accrued unpaid dividends converted to common stock           |    |       | 142,988   |
| Common stock issued in exchange for preferred stock and accrued unpaid dividends |    |       | 56,201    |

*See accompanying notes to consolidated financial statements.*

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**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. and Subsidiaries (herein referred to as the Company, we, us or our ) 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, 2011. 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 consolidated financial statements and the notes thereto have been reclassified to conform to the current period presentation. Such reclassifications had no effect on net income or shareholders equity for any periods presented.

**2. REGULATORY MATTERS**

In May 2011, the regulatory Consent Order (the Consent Order ) that Central Pacific Bank ( the bank or our bank ) entered into with the Federal Deposit Insurance Corporation (the FDIC ) and the Hawaii Division of Financial Institutions (the DFI ) on December 9, 2009 was lifted. In place of the Consent Order, the Board of Directors of the bank entered into a Memorandum of Understanding (the Bank MOU ) with the FDIC and DFI effective May 5, 2011. The Bank MOU continues a number of the same requirements previously required by the Consent Order, including the maintenance of an adequate allowance for loan and lease losses, improvement of our asset quality, limitations on credit extensions, maintenance of qualified management and the prohibition on cash dividends to Central Pacific Financial Corp. ( CPF ), among other matters. In addition, the Bank MOU requires the bank to further reduce classified assets below the level previously required by the Consent Order. The Bank MOU lowers the minimum leverage capital ratio that the bank is required to maintain from 10% in the Consent Order to 8% and does not mandate a minimum total risk-based capital ratio.

In addition to the Bank MOU, the Company continues to be subject to a Written Agreement (the Written Agreement ) with the Federal Reserve Bank of San Francisco (the FRBSF ) and DFI dated July 2, 2010, which superseded in its entirety the Memorandum of Understanding that the Company entered into on April 1, 2009 with the FRBSF and DFI. Among other matters, the Written Agreement provides that unless we receive the consent of the FRBSF and DFI, we cannot: (i) pay dividends; (ii) receive dividends or payments representing a reduction in capital from the bank; (iii) directly or through any non-bank subsidiaries make any payments on subordinated debentures or trust preferred securities; (iv) directly or through any non-bank subsidiaries incur, increase or guarantee any debt; or (v) purchase or redeem any shares of our stock. The Written Agreement also requires that our Board of Directors fully utilize the Company s financial and managerial resources to ensure that the bank complies with the Bank MOU and any other supervisory action taken by the bank s regulators. We were also required to submit to the FRBSF an acceptable capital plan and cash flow projection.

Even though the Consent Order has been replaced by the Bank MOU, the bank remains subject to a number of requirements as described above. We cannot assure you whether or when the Company and the bank will be in full compliance with the agreements with the regulators or whether or when the Bank MOU or the Written Agreement will be terminated. Even if terminated, we may still be subject to other agreements with regulators that restrict our activities and may also continue to impose capital ratios or other requirements on our business. The requirements and restrictions of the Bank MOU and the Written Agreement are judicially enforceable and the Company or the bank's failure to comply with such requirements and restrictions may subject the Company and the bank to additional regulatory restrictions including: the imposition of a new consent order, limitations on our activities, the imposition of civil monetary penalties; the termination of insurance of deposits; the issuance of removal and prohibition orders against institution-affiliated parties; the appointment of a conservator or receiver for the bank; the issuance of directives to increase capital or enter into a strategic transaction, whether by merger or otherwise, with a third party, if we again fall below the capital ratio requirement; and the enforcement of such actions through injunctions or restraining orders.

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**3. RECENT ACCOUNTING PRONOUNCEMENTS**

In April 2011, the Financial Accounting Standards Board ( FASB ) issued Accounting Standards Update ( ASU ) 2011-03, *Reconsideration of Effective Control for Repurchase Agreements*. The amendments in this ASU remove from the assessment of effective control the criterion requiring the transferor to have the ability to repurchase or redeem the financial assets on substantially the agreed terms, even in the event of default by the transferee. The amendments in this ASU also eliminate the requirement to demonstrate that the transferor possesses adequate collateral to fund substantially all the cost of purchasing replacement financial assets. This ASU is effective prospectively for transactions, or modifications of existing transactions, that occur on or after January 1, 2012. We adopted this ASU effective January 1, 2012 and the adoption of this guidance did not have a material impact on our consolidated financial statements.

In May 2011, the FASB issued ASU 2011-04, *Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs*. The amendments in this ASU generally represent clarifications of Topic 820, but also include some instances where a particular principle or requirement for measuring fair value or disclosing information about fair value measurements has changed. This ASU results in common principles and requirements for measuring fair value and for disclosing information about fair value measurements in accordance with U.S. GAAP and International Financial Reporting Standards ( IFRS ). The amendments in this ASU are to be applied prospectively effective January 1, 2012. We adopted this ASU effective January 1, 2012 and the adoption of this guidance did not have a material impact on our consolidated financial statements.

In June 2011, the FASB issued ASU 2011-05, *Amendments to Topic 220, Comprehensive Income*. Under the amendments in ASU 2011-5, an entity has the option to present the total of comprehensive income, the components of net income, and the components of other comprehensive income either in a single continuous statement of comprehensive income or in two separate but consecutive statements. In both choices, an entity is required to present each component of net income along with total net income, each component of other comprehensive income along with a total for other comprehensive income, and a total amount for comprehensive income. ASU 2011-05 eliminates the option to present the components of other comprehensive income as part of the statement of changes in stockholders' equity. The amendments in ASU 2011-5 do not change the items that must be reported in other comprehensive income or when an item of other comprehensive income must be reclassified to net income. ASU 2011-05 was effective for the interim reporting period beginning on or after January 1, 2012, with retrospective application required. In December 2011, the FASB issued ASU 2011-12, *Comprehensive Income: Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in ASU 2011-05*. The amendments in ASU 2011-12 supersede certain pending paragraphs in ASU 2011-05 to effectively defer only those changes in ASU 2011-05 that relate to the presentation of reclassification adjustments out of accumulated other comprehensive income. The amendments will be temporary to allow FASB time to redeliberate the presentation requirements for reclassifications out of accumulated other comprehensive income for annual and interim financial statements. ASU 2011-12, which shares the same effective date as ASU 2011-05, does not defer the requirement for entities to present components of comprehensive income in either a single continuous statement of comprehensive income or in two separate but consecutive statements. We adopted the provisions of ASU 2011-05 and ASU 2011-12 effective January 1, 2012 which resulted in a new statement of comprehensive income for the three month and six month periods ended June 30, 2012. The adoption of ASU 2011-05 and ASU 2011-12 had no impact on the Company's consolidated balance sheets and statements of income.

Table of Contents**4. INVESTMENT SECURITIES**

A summary of available for sale and held to maturity investment securities are as follows:

|   | Amortized<br>cost   | Gross<br>unrealized<br>gains<br>(Dollars in thousands) |  | Gross<br>unrealized<br>losses | Estimated<br>fair<br>value |
|---|---------------------|--|--|-------------------------------|----------------------------|
| <b>June 30, 2012</b>  |                     |  |  |                               |                            |
| <u>Available for Sale</u>                                     |                     |  |  |                               |                            |
| U.S. Government sponsored entities debt securities            | \$ 354,145          | \$ 3,148   |  | \$                            | \$ 357,293                 |
| States and political subdivisions debt securities             | 91,369              | 1,562  |  | (407)                         | 92,524                     |
| U.S. Government sponsored entities mortgage-backed securities | 1,115,487           | 19,227   |  | (1,864)                       | 1,132,850                  |
| Corporate securities  | 48,448              | 585  |  | (45)                          | 48,988                     |
| Other   | 848                 | 21   |  |                               | 869                        |
| <b>Total</b>  | <b>\$ 1,610,297</b> | <b>\$ 24,543</b>                                       |  | <b>\$ (2,316)</b>             | <b>\$ 1,632,524</b>        |
| <u>Held to Maturity</u>                                       |                     |  |  |                               |                            |
| U.S. Government sponsored entities mortgage-backed securities | \$ 487              | \$ 8   |  | \$                            | \$ 495                     |
| <b>December 31, 2011</b>                                      |                     |  |  |                               |                            |
| <u>Available for Sale</u>                                     |                     |  |  |                               |                            |
| U.S. Government sponsored entities debt securities            | \$ 370,184          | \$ 2,993   |  | \$                            | \$ 373,177                 |
| States and political subdivisions debt securities             | 12,265              | 729  |  |                               | 12,994                     |
| U.S. Government sponsored entities mortgage-backed securities | 1,077,146           | 20,981   |  | (825)                         | 1,097,302                  |
| Corporate securities  | 8,403               | 148  |  |                               | 8,551                      |
| Other   | 985                 |  |  | (15)                          | 970                        |
| <b>Total</b>  | <b>\$ 1,468,983</b> | <b>\$ 24,851</b>                                       |  | <b>\$ (840)</b>               | <b>\$ 1,492,994</b>        |
| <u>Held to Maturity</u>                                       |                     |  |  |                               |                            |
| U.S. Government sponsored entities mortgage-backed securities | \$ 931              | \$ 45  |  | \$                            | \$ 976                     |

The amortized cost and estimated fair value of investment securities at June 30, 2012 by contractual maturity are shown below. Expected maturities will differ from contractual maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties.

|                                       | June 30, 2012          |                         |
|---------------------------------------|------------------------|-------------------------|
|                                       | Amortized<br>Cost      | Estimated Fair<br>Value |
|                                       | (Dollars in thousands) |                         |
| <b>Available for Sale</b>             |                        |                         |
| Due in one year or less               | \$ 180,546             | \$ 181,200              |
| Due after one year through five years | 202,455                | 205,522                 |



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|  |              |              |
|--|--------------|--------------|
| Due after five years through ten years | 34,324       | 35,004       |
| Due after ten years                    | 76,637       | 77,079       |
| Mortgage-backed securities             | 1,115,487    | 1,132,850    |
| Other                                  | 848          | 869          |
| Total                                  | \$ 1,610,297 | \$ 1,632,524 |
| <b>Held to Maturity</b>                |              |              |
| Mortgage-backed securities             | \$ 487       | \$ 495       |

We sold certain available for sale investment securities during the three months ended June 30, 2012 for gross proceeds of \$2.7 million. We did not sell any available for sale securities during the first quarter of 2012. Gross realized gains and losses on the sales of the available for sale investment securities during the three months ended June 30, 2012 were less than \$1,000 and nil, respectively. The specific identification method was used as the basis for determining the cost of all securities sold.

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During the three months ended June 30, 2011, we sold certain available for sale investment securities for gross proceeds of \$5.3 million. We did not sell any available for sale securities during the first quarter of 2011. Gross realized gains and losses on the sales of the available for sale investment securities during the three months ended June 30, 2011 were \$0.3 million and nil, respectively. The specific identification method was also used as the basis for determining the cost of all securities sold.

Investment securities of \$871.2 million and \$938.0 million at June 30, 2012 and December 31, 2011, respectively, were pledged to secure public funds on deposit, securities sold under agreements to repurchase and other long-term and short-term borrowings. None of these securities were pledged to a secured party that has the right to sell or repledge the collateral as of the same periods.

Provided below is a summary of the 50 and nine investment securities which were in an unrealized loss position at June 30, 2012 and December 31, 2011, respectively.

| Description of Securities                                     | Less than 12 months |                   | 12 months or longer |                   | Total      |                   |
|---|---------------------|-------------------|---------------------|-------------------|------------|-------------------|
|   | Fair Value          | Unrealized Losses | Fair Value          | Unrealized Losses | Fair Value | Unrealized Losses |
| <b>(Dollars in thousands)</b>                                 |                     |                   |                     |                   |            |                   |
| <b>At June 30, 2012:</b>                                      |                     |                   |                     |                   |            |                   |
| States and political subdivisions debt securities             | \$ 32,896           | \$ (407)          | \$                  | \$                | \$ 32,896  | \$ (407)          |
| U.S. Government sponsored entities mortgage-backed securities | 276,434             | (1,864)           |                     |                   | 276,434    | (1,864)           |
| Corporate securities  | 6,825               | (45)              |                     |                   | 6,825      | (45)              |
| Total temporarily impaired securities                         | \$ 316,155          | \$ (2,316)        | \$                  | \$                | \$ 316,155 | \$ (2,316)        |
| <b>At December 31, 2011:</b>                                  |                     |                   |                     |                   |            |                   |
| U.S. Government sponsored entities mortgage-backed securities | \$ 144,520          | \$ (825)          | \$                  | \$                | \$ 144,520 | \$ (825)          |
| Other   | 970                 | (15)              |                     |                   | 970        | (15)              |
| Total temporarily impaired securities                         | \$ 145,490          | \$ (840)          | \$                  | \$                | \$ 145,490 | \$ (840)          |

Unrealized losses for all investment securities are reviewed to determine whether the losses are deemed other-than-temporary impairment ( OTTI ). Investment securities are evaluated for OTTI on at least a quarterly basis and more frequently when economic or market conditions warrant such an evaluation to determine whether a decline in their value below amortized cost is other-than-temporary. In conducting this assessment, we evaluate a number of factors including, but not limited to:

- The length of time and the extent to which fair value has been less than the amortized cost basis;
- Adverse conditions specifically related to the security, an industry, or a geographic area;
- The historical and implied volatility of the fair value of the security;

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- The payment structure of the debt security and the likelihood of the issuer being able to make payments;
- Failure of the issuer to make scheduled interest or principal payments;
- Any rating changes by a rating agency; and
- Recoveries or additional decline in fair value subsequent to the balance sheet date.

The term *other-than-temporary* is not intended to indicate that the decline is permanent, but indicates that the prospects for a near-term recovery of value are not necessarily favorable, or that there is a general lack of evidence to support a realizable value equal to or greater than the carrying value of the investment. Once a decline in value is determined to be *other-than-temporary*, the value of the security is reduced and a corresponding charge to earnings is recognized for anticipated credit losses.

The declines in market value were primarily attributable to changes in interest rates and disruptions in the credit and financial markets. Because we have no intent to sell securities in an unrealized loss position and it is not more likely than not that we will be required to sell such securities before recovery of its amortized cost basis, we do not consider these investments to be *other-than-temporarily* impaired.

Table of Contents**5. LOANS AND LEASES**

Loans and leases, excluding loans held for sale, consisted of the following:

|  | <b>June 30,<br/>2012</b>      | <b>December 31,<br/>2011</b> |
|--|-------------------------------|------------------------------|
|  | <b>(Dollars in thousands)</b> |                              |
| Commercial, financial and agricultural | \$ 197,613                    | \$ 180,571                   |
| Real estate:                           |                               |                              |
| Construction                           | 106,464                       | 161,126                      |
| Mortgage - residential                 | 977,999                       | 896,566                      |
| Mortgage - commercial                  | 698,756                       | 701,399                      |
| Consumer                               | 108,276                       | 108,810                      |
| Leases                                 | 13,934                        | 17,702                       |
|  | 2,103,042                     | 2,066,174                    |
| Unearned income                        | (1,879)                       | (1,727)                      |
| Total loans and leases                 | \$ 2,101,163                  | \$ 2,064,447                 |

During the six months ended June 30, 2012, we sold one loan with a carrying value of \$0.5 million and transferred one loan, which was non-performing, with a carrying value of \$0.3 million, to the held-for-sale category. In addition, we transferred 11 loans with a carrying value of \$2.0 million to other real estate. No portfolio loans were purchased during the six months ended June 30, 2012.

During the six months ended June 30, 2011, we transferred one loan, which was non-performing, with a carrying value of \$1.3 million, to the held-for-sale category. In addition, we transferred 17 loans with a carrying value of \$8.5 million to other real estate. No portfolio loans were sold or purchased during the six months ended June 30, 2011.

Table of Contents**Impaired Loans**

The following table presents by class, the balance in the allowance for loan and lease losses and the recorded investment in loans and leases based on the Company's impairment measurement method as of June 30, 2012 and December 31, 2011:

|                                       | Commercial,<br>financial &<br>agricultural | Construction | Real estate<br>Mortgage -<br>residential | Mortgage -<br>commercial | Consumer   | Leases    | Total        |
|---------------------------------------|--|--------------|--|--------------------------|------------|-----------|--------------|
|                                       | (Dollars in thousands)                     |              |  |                          |            |           |              |
| <b>June 30, 2012</b>                  |  |              |  |                          |            |           |              |
| Allowance for loan and lease losses:  |  |              |  |                          |            |           |              |
| Ending balance attributable to loans: |  |              |  |                          |            |           |              |
| Individually evaluated for impairment | \$ 994                                     | \$ 3,214     | \$ 847                                   | \$ 4                     | \$         | \$ 13     | \$ 5,072     |
| Collectively evaluated for impairment | 5,268                                      | 9,117        | 28,974                                   | 47,238                   | 2,008      | 137       | 92,742       |
|                                       | 6,262                                      | 12,331       | 29,821                                   | 47,242                   | 2,008      | 150       | 97,814       |
| Unallocated                           |  |              |  |                          |            |           | 6,000        |
| Total ending balance                  | \$ 6,262                                   | \$ 12,331    | \$ 29,821                                | \$ 47,242                | \$ 2,008   | \$ 150    | \$ 103,814   |
| Loans and leases:                     |  |              |  |                          |            |           |              |
| Individually evaluated for impairment | \$ 3,870                                   | \$ 47,598    | \$ 47,634                                | \$ 20,390                | \$         | \$ 265    | \$ 119,757   |
| Collectively evaluated for impairment | 193,743                                    | 58,866       | 930,365                                  | 678,366                  | 108,276    | 13,669    | 1,983,285    |
|                                       | 197,613                                    | 106,464      | 977,999                                  | 698,756                  | 108,276    | 13,934    | 2,103,042    |
| Unearned income                       | 78   | 1            | (535)                                    | (1,423)                  |            |           | (1,879)      |
| Total ending balance                  | \$ 197,691                                 | \$ 106,465   | \$ 977,464                               | \$ 697,333               | \$ 108,276 | \$ 13,934 | \$ 2,101,163 |
| <b>December 31, 2011</b>              |  |              |  |                          |            |           |              |
| Allowance for loan and lease losses:  |  |              |  |                          |            |           |              |
| Ending balance attributable to loans: |  |              |  |                          |            |           |              |
| Individually evaluated for impairment | \$   | \$ 401       | \$                                       | \$ 371                   | \$         | \$        | \$ 772       |
| Collectively evaluated for impairment | 6,110                                      | 28,229       | 32,736                                   | 47,358                   | 2,335      | 553       | 117,321      |
|                                       | 6,110                                      | 28,630       | 32,736                                   | 47,729                   | 2,335      | 553       | 118,093      |
| Unallocated                           |  |              |  |                          |            |           | 4,000        |
| Total ending balance                  | \$ 6,110                                   | \$ 28,630    | \$ 32,736                                | \$ 47,729                | \$ 2,335   | \$ 553    | \$ 122,093   |
| Loans and leases:                     |  |              |  |                          |            |           |              |
| Individually evaluated for impairment | \$ 1,367                                   | \$ 62,569    | \$ 50,221                                | \$ 18,451                | \$         | \$        | \$ 132,608   |
| Collectively evaluated for impairment | 179,204                                    | 98,557       | 846,345                                  | 682,948                  | 108,810    | 17,702    | 1,933,566    |
|                                       | 180,571                                    | 161,126      | 896,566                                  | 701,399                  | 108,810    | 17,702    | 2,066,174    |
| Unearned income                       | 133  | (63)         | (467)                                    | (1,330)                  |            |           | (1,727)      |
| Total ending balance                  | \$ 180,704                                 | \$ 161,063   | \$ 896,099                               | \$ 700,069               | \$ 108,810 | \$ 17,702 | \$ 2,064,447 |

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The following table presents by class, impaired loans as of June 30, 2012 and December 31, 2011:

|   | Unpaid Principal<br>Balance | Recorded<br>Investment<br>(Dollars in thousands) | Allowance<br>Allocated |
|---|-----------------------------|--|------------------------|
| <b>June 30, 2012</b>                                    |                             |  |                        |
| Impaired loans with no related allowance recorded:      |                             |  |                        |
| Commercial, financial & agricultural                    | \$ 1,026                    | \$ 326   | \$                     |
| Real estate:  |                             |  |                        |
| Construction  | 36,450                      | 29,881   |                        |
| Mortgage - residential                                  | 51,094                      | 45,028   |                        |
| Mortgage - commercial                                   | 18,110                      | 17,317   |                        |
| Total impaired loans with no related allowance recorded | 106,680                     | 92,552   |                        |
| Impaired loans with an allowance recorded:              |                             |  |                        |
| Commercial, financial & agricultural                    | 4,919                       | 3,544  | 994                    |
| Real estate:  |                             |  |                        |
| Construction  | 22,045                      | 17,717   | 3,214                  |
| Mortgage - residential                                  | 2,639                       | 2,606  | 847                    |
| Mortgage - commercial                                   | 4,110                       | 3,073  | 4                      |
| Leases  | 265                         | 265  | 13                     |
| Total impaired loans with an allowance recorded         | 33,978                      | 27,205   | 5,072                  |
| Total   | \$ 140,658                  | \$ 119,757                                       | \$ 5,072               |
| <b>December 31, 2011</b>                                |                             |  |                        |
| Impaired loans with no related allowance recorded:      |                             |  |                        |
| Commercial, financial & agricultural                    | \$ 2,107                    | \$ 1,367   | \$                     |
| Real estate:  |                             |  |                        |
| Construction  | 80,283                      | 47,877   |                        |
| Mortgage - residential                                  | 57,195                      | 50,221   |                        |
| Mortgage - commercial                                   | 14,084                      | 13,756   |                        |
| Total impaired loans with no related allowance recorded | 153,669                     | 113,221  |                        |
| Impaired loans with an allowance recorded:              |                             |  |                        |
| Real estate:  |                             |  |                        |
| Construction  | 24,262                      | 14,692   | 401                    |
| Mortgage - commercial                                   | 6,188                       | 4,695  | 371                    |
| Total impaired loans with an allowance recorded         | 30,450                      | 19,387   | 772                    |
| Total   | \$ 184,119                  | \$ 132,608                                       | \$ 772                 |

The following table presents by class, the average recorded investment and interest income recognized on impaired loans as of June 30, 2012 and 2011:

|                                      | Three Months Ended June 30,       |                                  |                                   |                                  | Six Months Ended June 30,         |                                  |                                   |                                  |
|--------------------------------------|-----------------------------------|----------------------------------|-----------------------------------|----------------------------------|-----------------------------------|----------------------------------|-----------------------------------|----------------------------------|
|                                      | 2012                              |                                  | 2011                              |                                  | 2012                              |                                  | 2011                              |                                  |
|                                      | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized |
| Commercial, financial & agricultural | \$ 4,275                          | \$ 26                            | \$ 404                            | \$                               | \$ 3,024                          | \$ 29                            | \$ 440                            | \$                               |
| Real estate:                         |                                   |                                  |                                   |                                  |                                   |                                  |                                   |                                  |

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|                        |            |        |            |        |            |          |            |          |
|------------------------|------------|--------|------------|--------|------------|----------|------------|----------|
| Construction           | 62,174     |        | 127,344    | 531    | 63,387     | 645      | 135,674    | 666      |
| Mortgage - residential | 48,817     | 121    | 58,801     | 32     | 49,438     | 178      | 59,509     | 445      |
| Mortgage - commercial  | 22,766     | 146    | 20,042     | 116    | 20,272     | 168      | 18,613     | 116      |
| Leases                 | 199        |        |            |        | 85         |          |            |          |
| Total                  | \$ 138,231 | \$ 293 | \$ 206,591 | \$ 679 | \$ 136,206 | \$ 1,020 | \$ 214,236 | \$ 1,227 |

Table of Contents**Aging Analysis of Accruing and Non-Accruing Loans and Leases**

For all loan types, the Company determines delinquency status by considering the number of days full payments required by the contractual terms of the loan are past due. The following table presents by class, the aging of the recorded investment in past due loans and leases as of June 30, 2012 and December 31, 2011:

|   | Accruing Loans<br>30 - 59 Days Past<br>Due | Accruing Loans<br>60 - 89 Days Past<br>Due | Accruing<br>Loans Greater<br>than 90 Days<br>Past Due | Nonaccrual<br>Loans | Total Past Due<br>and Nonaccrual | Loans and<br>Leases Not Past<br>Due | Total               |
|---|--|--|---|---------------------|----------------------------------|-------------------------------------|---------------------|
| (Dollars in thousands)                  |  |  |   |                     |                                  |                                     |                     |
| <b>June 30, 2012</b>                    |  |  |   |                     |                                  |                                     |                     |
| Commercial,<br>financial & agricultural | \$ 120                                     | \$ 43                                      | \$  | \$ 3,698            | \$ 3,861                         | \$ 193,830                          | \$ 197,691          |
| Real estate:                            |  |  |   |                     |                                  |                                     |                     |
| Construction                            |  | 1,546                                      | 319   | 47,598              | 49,463                           | 57,002                              | 106,465             |
| Mortgage - residential                  | 15   | 583  | 156   | 42,199              | 42,953                           | 934,511                             | 977,464             |
| Mortgage - commercial                   |  |  |   | 16,805              | 16,805                           | 680,528                             | 697,333             |
| Consumer                                | 410  | 533  | 3   |                     | 946                              | 107,330                             | 108,276             |
| Leases                                  |  | 12   | 27  | 264                 | 303                              | 13,631                              | 13,934              |
| <b>Total</b>                            | <b>\$ 545</b>                              | <b>\$ 2,717</b>                            | <b>\$ 505</b>   | <b>\$ 110,564</b>   | <b>\$ 114,331</b>                | <b>\$ 1,986,832</b>                 | <b>\$ 2,101,163</b> |
| <b>December 31, 2011</b>                |  |  |   |                     |                                  |                                     |                     |
| Commercial,<br>financial & agricultural | \$ 180                                     | \$ 80                                      | \$  | \$ 1,367            | \$ 1,627                         | \$ 179,077                          | \$ 180,704          |
| Real estate:                            |  |  |   |                     |                                  |                                     |                     |
| Construction                            |  | 442  |   | 57,351              | 57,793                           | 103,270                             | 161,063             |
| Mortgage - residential                  | 2,972                                      | 631  |   | 47,128              | 50,731                           | 845,368                             | 896,099             |
| Mortgage - commercial                   | 602  |  |   | 15,653              | 16,255                           | 683,814                             | 700,069             |
| Consumer                                | 390  | 79   | 28  |                     | 497                              | 108,313                             | 108,810             |
| Leases                                  | 28   |  |   |                     | 28                               | 17,674                              | 17,702              |
| <b>Total</b>                            | <b>\$ 4,172</b>                            | <b>\$ 1,232</b>                            | <b>\$ 28</b>  | <b>\$ 121,499</b>   | <b>\$ 126,931</b>                | <b>\$ 1,937,516</b>                 | <b>\$ 2,064,447</b> |

**Modifications**

Troubled debt restructurings ( TDRs ) included in nonperforming assets at June 30, 2012 consisted of 82 Hawaii residential mortgage loans with a combined principal balance of \$35.3 million, a Mainland construction and development loan with a principal balance of \$13.2 million, two Mainland commercial mortgage loans with a combined principal balance of \$6.4 million, seven Hawaii construction and development loans with a combined principal balance of \$2.8 million, a Hawaii commercial mortgage loan with a principal balance of \$0.5 million and a Hawaii commercial loan with a principal balance of \$0.2 million. Concessions made to the original contractual terms of these loans consisted primarily of the deferral of interest and/or principal payments due to deterioration in the borrowers' financial condition. The principal balances on these TDRs had matured and/or were in default at the time of restructure and we have no commitments to lend additional funds to any of these borrowers. There were \$9.2 million of TDRs still accruing interest at June 30, 2012, none of which were more than 90 days delinquent. At December 31, 2011, there were \$8.3 million of TDRs still accruing interest, none of which were more than 90 days delinquent.

The majority of loans modified in a TDR are typically on nonaccrual status. Thus, these loans have already been identified as impaired and have already been evaluated under the Company's allowance for loan and lease losses (the Allowance) methodology. As a result, the loans modified in a TDR did not have a material affect to our provision for loan and lease losses expense (the Provision) and the Allowance during the three and



six months ended June 30, 2012.

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The following table presents by class, information related to loans modified in a TDR during the three and six months ended June 30, 2012 and 2011:

|   | Number of<br>Contracts | Recorded<br>Investment<br>(as of<br>period end)<br>(Dollars in thousands) | Additional<br>Partial<br>Charge-offs |
|---|------------------------|---|--------------------------------------|
| <b>Three months ended June 30, 2012</b> |                        |   |                                      |
| Real estate:                            |                        |   |                                      |
| Construction                            | 4                      | \$ 1,603  | \$                                   |
| Mortgage - residential                  | 1                      | 351   |                                      |
| Mortgage - commercial                   | 2                      | 3,438   |                                      |
| Total                                   | 7                      | \$ 5,392  | \$                                   |
| <b>Three months ended June 30, 2011</b> |                        |   |                                      |
| Real estate:                            |                        |   |                                      |
| Construction                            | 1                      | \$ 5,413  | \$                                   |
| Mortgage - residential                  | 14                     | 6,065   | 27                                   |
| Total                                   | 15                     | \$ 11,478   | \$ 27                                |
| <b>Six months ended June 30, 2012</b>   |                        |   |                                      |
| Real estate:                            |                        |   |                                      |
| Construction                            | 4                      | \$ 1,603  | \$                                   |
| Mortgage - residential                  | 7                      | 3,560   |                                      |
| Mortgage - commercial                   | 4                      | 10,214  |                                      |
| Total                                   | 15                     | \$ 15,377   | \$                                   |
| <b>Six months ended June 30, 2011</b>   |                        |   |                                      |
| Real estate:                            |                        |   |                                      |
| Construction                            | 2                      | \$ 10,841   | \$ 3,014                             |
| Mortgage - residential                  | 22                     | 8,010   | 447                                  |
| Total                                   | 24                     | \$ 18,851   | \$ 3,461                             |

The following table presents by class, loans modified as a TDR within the previous twelve months that subsequently defaulted during the three and six months ended June 30, 2012 and 2011:

|                        | Three Months Ended June 30, |   |                        |   | Six Months Ended June 30, |   |                        |   |
|------------------------|-----------------------------|---|------------------------|---|---------------------------|---|------------------------|---|
|                        | 2012                        |   | 2011                   |   | 2012                      |   | 2011                   |   |
|                        | Number of<br>Contracts      | Recorded<br>Investment<br>(as of period<br>end) | Number of<br>Contracts | Recorded<br>Investment<br>(as of period<br>end)<br>(Dollars in thousands) | Number of<br>Contracts    | Recorded<br>Investment<br>(as of period<br>end) | Number of<br>Contracts | Recorded<br>Investment<br>(as of period<br>end) |
| Real estate:           |                             |   |                        |   |                           |   |                        |   |
| Construction           | 4                           | \$ 1,603  | 1                      | \$ 5,242  | 4                         | \$ 1,603  | 1                      | \$ 5,242  |
| Mortgage - residential | 1                           | 351   | 10                     | 5,113   | 3                         | 796   | 17                     | 6,830   |
| Mortgage - commercial  | 1                           | 3,307   |                        |   | 2                         | 6,465   |                        |   |
| Total                  | 6                           | \$ 5,261  | 11                     | \$ 10,355   | 9                         | \$ 8,864  | 18                     | \$ 12,072                                       |



Table of Contents**Credit Quality Indicators**

The Company categorizes loans and leases into risk categories based on relevant information about the ability of borrowers to service their debt such as: current financial information, historical payment experience, credit documentation, public information, and current economic trends, among other factors. The Company analyzes loans and leases individually by classifying the loans and leases as to credit risk. This analysis includes loans and leases with an outstanding balance greater than \$0.5 million or \$1.0 million, depending on loan type, and non-homogeneous loans and leases, such as commercial and commercial real estate loans. This analysis is performed on a quarterly basis. The Company uses the following definitions for risk ratings:

**Special Mention.** Loans and leases classified as special mention, while still adequately protected by the borrower's capital adequacy and payment capability, exhibit distinct weakening trends and/or elevated levels of exposure to external conditions. If left unchecked or uncorrected, these potential weaknesses may result in deteriorated prospects of repayment. These exposures require management's close attention so as to avoid becoming undue or unwarranted credit exposures.

**Substandard.** Loans and leases classified as substandard are inadequately protected by the borrower's current financial condition and payment capability or of the collateral pledged, if any. Loans and leases so classified have a well-defined weakness or weaknesses that jeopardize the orderly repayment of debt. They are characterized by the distinct possibility that the bank will sustain some loss if the deficiencies are not corrected.

**Doubtful.** Loans and leases classified as doubtful have all the weaknesses inherent in those classified as substandard, with the added characteristic that the weaknesses make collection or orderly repayment in full, on the basis of current existing facts, conditions and values, highly questionable and improbable. Possibility of loss is extremely high, but because of certain important and reasonably specific factors that may work to the advantage and strengthening of the exposure, its classification as an estimate loss is deferred until its more exact status may be determined.

**Loss.** Loans and leases classified as loss are considered to be non-collectible and of such little value that their continuance as bankable assets is not warranted. This does not mean the loan has absolutely no recovery value, but rather it is neither practical nor desirable to defer writing off the loan, even though partial recovery may be obtained in the future. Losses are taken in the period in which they surface as uncollectible.

Loans and leases not meeting the criteria above that are analyzed individually as part of the process described above are considered to be pass rated loans and leases. Loans and leases listed as not rated are either less than \$0.5 million or are included in groups of homogeneous loan pools. The following table presents by class and credit indicator, the recorded investment in the Company's loans and leases as of June 30, 2012 and December 31, 2011:

|                      | Pass | Special<br>Mention | Substandard | Doubtful | Loss | Not Rated | Less:<br>Unearned<br>Income | Total |
|----------------------|------|--------------------|-------------|----------|------|-----------|-----------------------------|-------|
| <b>June 30, 2012</b> |      |                    |             |          |      |           |                             |       |

(Dollars in thousands)

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|                                      |    |         |    |        |    |         |    |  |    |           |    |       |    |           |
|--------------------------------------|----|---------|----|--------|----|---------|----|--|----|-----------|----|-------|----|-----------|
| Commercial, financial & agricultural | \$ | 129,218 | \$ | 6,965  | \$ | 9,334   | \$ |  | \$ | 52,096    | \$ | (78)  | \$ | 197,691   |
| Real estate:                         |    |         |    |        |    |         |    |  |    |           |    |       |    |           |
| Construction                         |    | 37,931  |    | 16,503 |    | 48,594  |    |  |    | 3,436     |    | (1)   |    | 106,465   |
| Mortgage - residential               |    | 81,036  |    | 1,628  |    | 46,966  |    |  |    | 848,369   |    | 535   |    | 977,464   |
| Mortgage - commercial                |    | 569,172 |    | 71,892 |    | 32,916  |    |  |    | 24,776    |    | 1,423 |    | 697,333   |
| Consumer                             |    | 9,931   |    |        |    |         |    |  |    | 98,345    |    |       |    | 108,276   |
| Leases                               |    | 12,911  |    | 241    |    | 782     |    |  |    |           |    |       |    | 13,934    |
| Total                                | \$ | 840,199 | \$ | 97,229 | \$ | 138,592 | \$ |  | \$ | 1,027,022 | \$ | 1,879 | \$ | 2,101,163 |

**December 31, 2011**

|                                      |    |         |    |        |    |         |    |  |    |         |    |       |    |           |
|--------------------------------------|----|---------|----|--------|----|---------|----|--|----|---------|----|-------|----|-----------|
| Commercial, financial & agricultural | \$ | 107,419 | \$ | 6,087  | \$ | 15,389  | \$ |  | \$ | 51,676  | \$ | (133) | \$ | 180,704   |
| Real estate:                         |    |         |    |        |    |         |    |  |    |         |    |       |    |           |
| Construction                         |    | 52,882  |    | 18,808 |    | 84,716  |    |  |    | 4,720   |    | 63    |    | 161,063   |
| Mortgage - residential               |    | 62,314  |    | 3,823  |    | 55,017  |    |  |    | 775,412 |    | 467   |    | 896,099   |
| Mortgage - commercial                |    | 557,494 |    | 54,170 |    | 58,599  |    |  |    | 31,136  |    | 1,330 |    | 700,069   |
| Consumer                             |    | 4,659   |    |        |    | 79      |    |  |    | 104,072 |    |       |    | 108,810   |
| Leases                               |    | 16,111  |    | 327    |    | 1,264   |    |  |    |         |    |       |    | 17,702    |
| Total                                | \$ | 800,879 | \$ | 83,215 | \$ | 215,064 | \$ |  | \$ | 967,016 | \$ | 1,727 | \$ | 2,064,447 |

In accordance with applicable Interagency Guidance issued by our primary bank regulators, we define subprime borrowers as typically having weakened credit histories that include payment delinquencies and possibly more severe problems such as charge-offs, judgments, and bankruptcies. They may also display reduced repayment capacity as measured by credit scores, debt-to-income ratios, or other criteria that may encompass borrowers with incomplete credit histories. Subprime loans are loans to borrowers displaying one or more of these characteristics at the time of origination or purchase. Such loans have a higher risk of default than loans to prime borrowers. At June 30, 2012 and December 31, 2011, we did not have any loans that we considered to be subprime.

Table of Contents**6. ALLOWANCE FOR LOAN AND LEASE LOSSES**

The following table presents by class, the activity in the Allowance for the periods indicated:

|   | Commercial,<br>financial &<br>agricultural | Construction | Real estate<br>Mortgage -<br>residential | Mortgage -<br>commercial<br>(Dollars in thousands) | Consumer | Leases   | Unallocated | Total      |
|---|--|--------------|--|--|----------|----------|-------------|------------|
| <b>Three Months Ended<br/>June 30, 2012</b>     |  |              |  |  |          |          |             |            |
| Beginning balance                               | \$ 5,301                                   | \$ 21,380    | \$ 33,445                                | \$ 45,911  | \$ 2,105 | \$ 180   | \$ 6,000    | \$ 114,322 |
| Provision (credit) for<br>loan and lease losses | 1,523                                      | (6,079)      | (3,713)                                  | 1,649  | 22       | (32)     |             | (6,630)    |
|   | 6,824                                      | 15,301       | 29,732                                   | 47,560   | 2,127    | 148      | 6,000       | 107,692    |
| Charge-offs                                     | (1,394)                                    | (3,715)      | (173)                                    | (320)  | (323)    |          |             | (5,925)    |
| Recoveries                                      | 832  | 745          | 262                                      | 2  | 204      | 2        |             | 2,047      |
| Net charge-offs                                 | (562)                                      | (2,970)      | 89                                       | (318)  | (119)    | 2        |             | (3,878)    |
| Ending balance                                  | \$ 6,262                                   | \$ 12,331    | \$ 29,821                                | \$ 47,242  | \$ 2,008 | \$ 150   | \$ 6,000    | \$ 103,814 |
| <b>Three Months Ended<br/>June 30, 2011</b>     |  |              |  |  |          |          |             |            |
| Beginning balance                               | \$ 11,134                                  | \$ 59,078    | \$ 30,823                                | \$ 68,991  | \$ 2,451 | \$ 1,533 | \$ 4,000    | \$ 178,010 |
| Provision (credit) for<br>loan and lease losses | 1,094                                      | (6,137)      | (1,365)                                  | (2,482)  | 852      | (746)    |             | (8,784)    |
|   | 12,228                                     | 52,941       | 29,458                                   | 66,509   | 3,303    | 787      | 4,000       | 169,226    |
| Charge-offs                                     | (455)                                      | (3,000)      | (1,263)                                  | (879)  | (597)    |          |             | (6,194)    |
| Recoveries                                      | 854  | 2,549        | 231                                      | 3  | 265      |          |             | 3,902      |
| Net charge-offs                                 | 399  | (451)        | (1,032)                                  | (876)  | (332)    |          |             | (2,292)    |
| Ending balance                                  | \$ 12,627                                  | \$ 52,490    | \$ 28,426                                | \$ 65,633  | \$ 2,971 | \$ 787   | \$ 4,000    | \$ 166,934 |
| <b>Six Months Ended<br/>June 30, 2012</b>       |  |              |  |  |          |          |             |            |
| Beginning balance                               | \$ 6,110                                   | \$ 28,630    | \$ 32,736                                | \$ 47,729  | \$ 2,335 | \$ 553   | \$ 4,000    | \$ 122,093 |
| Provision (credit) for<br>loan and lease losses | 2,126                                      | (12,128)     | (2,921)                                  | (171)  | (148)    | (378)    | 2,000       | (11,620)   |
|   | 8,236                                      | 16,502       | 29,815                                   | 47,558   | 2,187    | 175      | 6,000       | 110,473    |
| Charge-offs                                     | (3,076)                                    | (5,341)      | (373)                                    | (320)  | (749)    | (28)     |             | (9,887)    |
| Recoveries                                      | 1,102                                      | 1,170        | 379                                      | 4  | 570      | 3        |             | 3,228      |
| Net charge-offs                                 | (1,974)                                    | (4,171)      | 6  | (316)  | (179)    | (25)     |             | (6,659)    |
| Ending balance                                  | \$ 6,262                                   | \$ 12,331    | \$ 29,821                                | \$ 47,242  | \$ 2,008 | \$ 150   | \$ 6,000    | \$ 103,814 |
| <b>Six Months Ended<br/>June 30, 2011</b>       |  |              |  |  |          |          |             |            |
| Beginning balance                               | \$ 13,426                                  | \$ 76,556    | \$ 31,830                                | \$ 64,308  | \$ 3,155 | \$ 1,579 | \$ 2,000    | \$ 192,854 |
| Provision (credit) for<br>loan and lease losses | (224)                                      | (13,123)     | (1,036)                                  | 2,388  | 428      | (792)    | 2,000       | (10,359)   |
|   | 13,202                                     | 63,433       | 30,794                                   | 66,696   | 3,583    | 787      | 4,000       | 182,495    |
| Charge-offs                                     | (1,861)                                    | (16,858)     | (3,299)                                  | (1,105)  | (1,202)  |          |             | (24,325)   |
| Recoveries                                      | 1,286                                      | 5,915        | 931                                      | 42   | 590      |          |             | 8,764      |
| Net charge-offs                                 | (575)                                      | (10,943)     | (2,368)                                  | (1,063)  | (612)    |          |             | (15,561)   |
| Ending balance                                  | \$ 12,627                                  | \$ 52,490    | \$ 28,426                                | \$ 65,633  | \$ 2,971 | \$ 787   | \$ 4,000    | \$ 166,934 |

Our Provision was a credit of \$6.6 million and \$11.6 million in the second quarter and first half of 2012, respectively, compared to a credit of \$8.8 million and \$10.4 million in the second quarter and first half of 2011. The decrease in our Allowance is directly attributable to continued improvement in our credit risk profile as evidenced by the decline in nonperforming assets.

In determining the amount of our Allowance, we rely on an analysis of our loan portfolio, our experience and our evaluation of general economic conditions, as well as regulatory requirements and input. If our assumptions prove to be incorrect, our current Allowance may not be sufficient to cover future loan losses and we may experience increases to our Provision.

## **7. SECURITIZATIONS**

In prior years, we securitized certain residential mortgage loans with a U.S. Government sponsored entity and continue to service the residential mortgage loans. The servicing assets were recorded at their respective fair values at the time of securitization. The fair value of the servicing assets was determined using a discounted cash flow model based on market value assumptions at the time of securitization and is amortized in proportion to and over the period of net servicing income.

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All unsold mortgage-backed securities were categorized as available for sale securities and were therefore recorded at their fair value of \$8.6 million and \$9.9 million at June 30, 2012 and December 31, 2011, respectively. The fair values of these mortgage-backed securities were based on quoted prices of similar instruments in active markets. Unrealized gains of \$0.5 million on unsold mortgage-backed securities were recorded in accumulated other comprehensive income ( AOCI ) at June 30, 2012 and December 31, 2011.

**8. OTHER INTANGIBLE ASSETS**

Other intangible assets include a core deposit premium, mortgage servicing rights, customer relationships and non-compete agreements. The following table presents changes in other intangible assets for the six months ended June 30, 2012:

|                              | Core<br>Deposit<br>Premium | Mortgage<br>Servicing<br>Rights | Customer<br>Relationships<br>(Dollars in thousands) | Non-Compete<br>Agreements | Total     |
|------------------------------|----------------------------|---------------------------------|---|---------------------------|-----------|
| Balance, beginning of period | \$ 18,053                  | \$ 22,933                       | \$ 910  | \$ 90                     | \$ 41,986 |
| Additions                    |                            | 2,506                           |   |                           | 2,506     |
| Amortization                 | (1,338)                    | (2,454)                         | (58)  | (25)                      | (3,875)   |
| Impairment charges           |                            |                                 | (852)   | (65)                      | (917)     |
| Balance, end of period       | \$ 16,715                  | \$ 22,985                       | \$  | \$                        | \$ 39,700 |

During the second quarter of 2012, we evaluated the recoverability of the intangible assets related to our customer relationships and non-compete agreements, both of which related to the 2008 asset acquisition of Pacific Islands Financial Management. Upon completion of this review, we determined that the intangible assets related to our customer relationships and non-compete agreements were both fully impaired, and thus, we recorded impairment charges to other operating expense of \$852,000 and \$65,000, respectively.

Income generated as the result of new mortgage servicing rights is reported as gains on sales of loans and totaled \$1.3 million and \$2.5 million for the three and six months ended June 30, 2012, respectively, compared to \$0.7 million and \$2.1 million for the three and six months ended June 30, 2011. Amortization of mortgage servicing rights was \$1.4 million and \$2.5 million for the three and six months ended June 30, 2012, respectively, compared to \$0.9 million and \$1.7 million for the three and six months ended June 30, 2011, respectively.

The following table presents the fair market value and key assumptions used in determining the fair market value of our mortgage servicing rights:

|  | Six Months Ended June 30, |           |
|--|---------------------------|-----------|
|  | 2012                      | 2011      |
|  | (Dollars in thousands)    |           |
| Fair market value, beginning of period | \$ 23,149                 | \$ 23,709 |
| Fair market value, end of period       | 23,359                    | 23,190    |
| Weighted average discount rate         | 8.0%                      | 8.5%      |



|  |      |      |
|--|------|------|
| Weighted average prepayment speed assumption | 14.2 | 14.5 |
|--|------|------|

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The gross carrying value and accumulated amortization related to our intangible assets are presented below:

|                           | June 30, 2012          |                          |           | December 31, 2011    |                          |           |
|---------------------------|------------------------|--------------------------|-----------|----------------------|--------------------------|-----------|
|                           | Gross Carrying Value   | Accumulated Amortization | Net       | Gross Carrying Value | Accumulated Amortization | Net       |
|                           | (Dollars in thousands) |                          |           |                      |                          |           |
| Core deposit premium      | \$ 44,642              | \$ (27,927)              | \$ 16,715 | \$ 44,642            | \$ (26,589)              | \$ 18,053 |
| Mortgage servicing rights | 48,553                 | (25,568)                 | 22,985    | 46,047               | (23,114)                 | 22,933    |
| Customer relationships    | 1,400                  | (1,400)                  |           | 1,400                | (490)                    | 910       |
| Non-compete agreements    | 300                    | (300)                    |           | 300                  | (210)                    | 90        |
|                           | \$ 94,895              | \$ (55,195)              | \$ 39,700 | \$ 92,389            | \$ (50,403)              | \$ 41,986 |

Based on the core deposit premium and mortgage servicing rights held as of June 30 2012, estimated amortization expense for the remainder of fiscal 2012, the next five succeeding fiscal years and all years thereafter are as follows:

|                  | Estimated Amortization Expense |                           |           |
|------------------|--------------------------------|---------------------------|-----------|
|                  | Core Deposit Premium           | Mortgage Servicing Rights | Total     |
|                  | (Dollars in thousands)         |                           |           |
| 2012 (remainder) | \$ 1,337                       | \$ 1,955                  | \$ 3,292  |
| 2013             | 2,674                          | 3,062                     | 5,736     |
| 2014             | 2,674                          | 2,690                     | 5,364     |
| 2015             | 2,674                          | 2,332                     | 5,006     |
| 2016             | 2,674                          | 2,002                     | 4,676     |
| 2017             | 2,674                          | 1,739                     | 4,413     |
| Thereafter       | 2,008                          | 9,205                     | 11,213    |
|                  | \$ 16,715                      | \$ 22,985                 | \$ 39,700 |

We perform an impairment assessment of our other intangible assets whenever events or changes in circumstance indicate that the carrying value of those assets may not be recoverable. Our impairment assessments involve, among other valuation methods, the estimation of future cash flows and other methods of determining fair value. Estimating future cash flows and determining fair values is subject to judgment and often involves the use of significant estimates and assumptions. The variability of the factors we use to perform our impairment tests depend on a number of conditions, including the uncertainty about future events and cash flows. All such factors are interdependent and, therefore, do not change in isolation. Accordingly, our accounting estimates may materially change from period to period due to changing market factors.

## 9. DERIVATIVES

We utilize various designated and undesignated derivative financial instruments to reduce our exposure to movements in interest rates including interest rate swaps, interest rate lock commitments and forward sale commitments. We measure all derivatives at fair value on our consolidated

balance sheet. In each reporting period, we record the derivative instruments in other assets or other liabilities depending on whether the derivatives are in an asset or liability position. For derivative instruments that are designated as hedging instruments, we record the effective portion of the changes in the fair value of the derivative in AOCI, net of tax, until earnings are affected by the variability of cash flows of the hedged transaction. We immediately recognize the portion of the gain or loss in the fair value of the derivative that represents hedge ineffectiveness in current period earnings. For derivative instruments that are not designated as hedging instruments, changes in the fair value of the derivative are included in current period earnings.

#### **Interest Rate Lock and Forward Sale Commitments**

We enter into interest rate lock commitments on certain mortgage loans that are intended to be sold. To manage interest rate risk on interest rate lock commitments, we also enter into forward loan sale commitments. The interest rate lock and forward loan sale commitments are accounted for as undesignated derivatives and are recorded at their respective fair values in other assets or other liabilities, with changes in fair value recorded in current period earnings. These instruments serve to reduce our exposure to movements in interest rates. At June 30, 2012, we were a party to interest rate lock and forward sale commitments on \$135.3 million and \$49.1 million of mortgage loans, respectively.

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The following table presents the location of all assets and liabilities associated with our derivative instruments within the consolidated balance sheet:

| Derivatives not designated as hedging instruments | Balance Sheet Location           | Asset Derivatives           |                                 | Liability Derivatives       |                                 |
|---|----------------------------------|-----------------------------|---------------------------------|-----------------------------|---------------------------------|
|   |                                  | Fair Value at June 30, 2012 | Fair Value at December 31, 2011 | Fair Value at June 30, 2012 | Fair Value at December 31, 2011 |
| Interest rate contracts                           | Other assets / other liabilities | \$ 1,266                    | \$ 545                          | \$ 435                      | \$ 443                          |

The following table presents the impact of derivative instruments and their location within the consolidated statements of income:

| Derivatives in Cash Flow Hedging Relationship | Amount of Gain Reclassified from AOCI into Earnings (Effective Portion)<br>(Dollars in thousands) |
|---|---|
| <b>Three Months Ended June 30, 2012</b>       |   |
| Interest rate contracts                       | \$ 359  |
| <b>Three Months Ended June 30, 2011</b>       |   |
| Interest rate contracts                       | 801   |
| <b>Six Months Ended June 30, 2012</b>         |   |
| Interest rate contracts                       | 931   |
| <b>Six Months Ended June 30, 2011</b>         |   |
| Interest rate contracts                       | 1,917   |

Amounts recognized in AOCI are net of income taxes. Amounts reclassified from AOCI into income are included in interest income in the consolidated statements of income. The ineffective portion has been recognized as other operating income in the consolidated statements of income.

| Derivatives not in Cash Flow Hedging Relationship | Location of Gain (Loss) Recognized in Earnings on Derivatives | Amount of Gain (Loss) Recognized in Earnings on Derivatives<br>(Dollars in thousands) |
|---|---|---|
| <b>Three Months Ended June 30, 2012</b>           |   |   |
| Interest rate contracts                           | Other operating income  | \$ 576  |
| <b>Three Months Ended June 30, 2011</b>           |   |   |
| Interest rate contracts                           | Other operating income  | (106)   |
| <b>Six Months Ended June 30, 2012</b>             |   |   |
| Interest rate contracts                           | Other operating income  | 729   |
| <b>Six Months Ended June 30, 2011</b>             |   |   |
| Interest rate contracts                           | Other operating income  | 173   |

**10. SHORT-TERM BORROWINGS AND LONG-TERM DEBT**

At June 30, 2012, our bank maintained a \$29.6 million line of credit with the Federal Reserve discount window, of which there were no advances outstanding. As of June 30, 2012, certain commercial and commercial real estate loans totaling \$49.3 million have been pledged as collateral on our line of credit with the Federal Reserve discount window. The Federal Reserve does not have the right to sell or repledge these loans. In September 2011, the bank was upgraded from the Federal Reserve's secondary credit facility to the primary credit facility, and regained its eligibility for the Borrower-in-Custody program. As of June 30, 2012, the bank continues to have access to the primary credit facility and remains eligible for the Borrower-in-Custody program.

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The bank is a member of and maintained an \$808.4 million line of credit with the Federal Home Loan Bank of Seattle (the FHLB ) as of June 30, 2012. Long-term borrowings under this arrangement totaled \$40,000 at June 30, 2012, compared to \$50.0 million at December 31, 2011. There were no short-term borrowings under this arrangement at June 30, 2012 and December 31, 2011.

In February 2009, the bank's collateral arrangement with the FHLB converted from a blanket pledge arrangement to a physical possession arrangement whereby the bank was required to deliver certain original loan documents to the FHLB for the collateral securing advances. In December 2010, the FHLB expanded the physical possession collateral arrangement to require copies of all loan documents for the collateral securing advances. In September 2011, the FHLB removed the physical possession requirement and replaced it with a listing arrangement whereby the bank now only needs to provide the FHLB with a monthly list of pledged assets that will be used to secure all advances. At June 30, 2012 the bank's pledged assets to the FHLB included investment securities with a fair value of \$169.2 million and certain real estate loans totaling \$986.8 million. The FHLB discounts the fair value of pledged assets, resulting in total borrowing capacity of \$808.4 million, \$40,000 of which was drawn at June 30, 2012.

On August 20, 2009, we began deferring regularly scheduled interest payments on our outstanding junior subordinated debentures relating to our trust preferred securities. The terms of the junior subordinated debentures and the trust documents allow us to defer payments of interest for up to 20 consecutive quarterly periods without default or penalty. During the deferral period, which currently stands at 12 consecutive quarters, the respective trusts have suspended the declaration and payment of dividends on the trust preferred securities. Also during the deferral period, we may not, among other things and with limited exceptions, pay cash dividends on or repurchase our common stock or make any payment on outstanding debt obligations that rank equally with or junior to the junior subordinated debentures. During the deferral period, we will continue to accrue, and reflect in our consolidated financial statements, the deferred interest payments on our junior subordinated debentures. Accrued interest on our outstanding junior subordinated debentures relating to our trust preferred securities was \$10.3 million and \$8.5 million at June 30, 2012 and December 31, 2011, respectively.

## 11. EQUITY

As previously announced, during fiscal 2011, we completed a number of significant transactions as part of our recapitalization, including:

- on February 2, 2011, we effected a one-for-twenty reverse stock split of our common stock (the Reverse Stock Split ). Except as otherwise specified, the share and per share amounts for historical periods have been restated to give the effect to the Reverse Stock Split;
- on February 18, 2011, we completed the Private Placement with investments from (1) affiliates of each of The Carlyle Group ( Carlyle ) and Anchorage Capital Group, L.L.C. (together with Carlyle, the Lead Investors ) pursuant to investment agreements with each of the Lead Investors and (2) various other investors, including certain of our directors and officers, pursuant to subscription agreements with each of such investors;
- concurrently with the closing of the Private Placement, we completed the exchange of 135,000 shares of our Fixed Rate Cumulative Perpetual Preferred Stock, no par value per share and liquidation preference \$1,000 per share, held by the United States Department of the Treasury (the Treasury ), and accrued and unpaid dividends thereon for 5,620,117 common shares (the TARP Exchange ). We also amended the warrant held by the Treasury (the Amended TARP Warrant ) to, among other things, reduce the exercise price from \$255.40 per share to \$10 per

share. The warrant grants the Treasury the right to purchase 79,288 common shares, subject to adjustment; and

- on May 6, 2011, we completed a \$20 million common stock rights offering which allowed shareholders of record as of the close of business on February 17, 2011 or their transferees to purchase newly issued common shares at \$10 per share.

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The TARP Exchange resulted in a non-cash increase in net income available to common shareholders of \$85.1 million in the first quarter of 2011 as the book value of the preferred stock plus accrued and unpaid dividends was greater than the estimated fair value of the common stock issued to the Treasury of \$56.2 million and the fair value of the Amended TARP Warrant at the time of the TARP Exchange. This accounting treatment had no effect on our total shareholders' equity or our regulatory capital position.

In addition to adjusting the exercise price of the Amended TARP Warrant, its terms were revised to include a down-round provision allowing for the future adjustment to the exercise price for any subsequent issuances of common stock by the Company. Subject to certain exceptions, if the Company subsequently issues common stock, or rights or shares convertible into common stock, at a per share price lower than the \$10 exercise price of the warrant, the exercise price of the warrant will be reduced to the per share common stock amount received in connection with the issuance and the number of shares of common stock subject to the warrant will be increased. This provision resulted in the warrant being carried as a derivative liability as compared to a common stock equivalent for balance sheet purposes as it possesses the characteristics of a freestanding derivative financial instrument as defined by Accounting Standards Codification (ASC) 815-10-15-83, *Accounting for Derivatives and Hedging*, and similar to the example illustrated in ASC 815-40-55-33 and -34. As a derivative liability, the warrant is carried at fair value, with subsequent remeasurements recorded through the current period's earnings. The initial value attributed to the warrant was \$1.7 million, with the fair value estimated using the Black-Scholes options pricing model, with the following assumptions: 67% volatility, a risk-free rate of 3.59%, a yield of 1.45% and an estimated life of 10 years. From February 18, 2011 through December 31, 2011, this instrument's estimated fair value decreased, which resulted in the recognition of \$1.0 million recorded in other noninterest income during the first half of 2011 and year ended December 31, 2011. From January 1, 2012 to June 30, 2012, this instrument's estimated fair value slightly increased, which resulted in the recognition of \$0.1 million recorded in other noninterest expense during the three and six months ended June 30, 2012.

On June 22, 2011, the Treasury completed a public underwritten offering of 2,850,000 shares of our common stock it received in the TARP Exchange. On April 4, 2012, the Treasury completed another public underwritten offering of its remaining 2,770,117 shares of our common stock it received in the TARP Exchange. The Company did not receive any proceeds from either of these offerings. The Treasury continues to hold the above mentioned warrant to purchase 79,288 shares of our common stock but no longer holds any of our common stock.

In 2009, our Board of Directors suspended the payment of all cash dividends on our common stock. Our ability to pay dividends with respect to common stock is subject to obtaining approval from the FRBSF and DFI, and is restricted until our obligations under our trust preferred securities are brought current. Additionally, our ability to pay dividends depends on our ability to obtain dividends from our bank. In addition to obtaining approval from the FDIC and DFI, Hawaii law only permits Central Pacific Bank to pay dividends out of retained earnings. Given that the bank had an accumulated deficit of \$414.1 million at June 30, 2012, the bank is prohibited from paying any dividends until this deficit is eliminated. Accordingly, we do not anticipate that the bank will be permitted to pay dividends for the foreseeable future.

## 12. SHARE-BASED COMPENSATION

### Stock Option Activity

The following is a summary of stock option activity for the Company's stock option plans for the six months ended June 30, 2012:

Weighted Average



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|                                | Shares  |    | Exercise Price |
|--------------------------------|---------|----|----------------|
| Outstanding at January 1, 2012 | 40,166  | \$ | 428.16         |
| Changes during the period      |         |    |                |
| Granted                        | 304,959 |    | 14.31          |
| Outstanding at June 30, 2012   | 345,125 |    | 62.47          |

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We estimate the fair value of stock options granted using the Black-Scholes option pricing formula and a single option award approach. This fair value is then amortized on a straight-line basis over the requisite periods of the awards, which is generally the vesting period. The fair value of the Company's stock options granted to employees for the three and six months ended June 30, 2012 was estimated using the following weighted-average assumptions:

|                             | <b>Three and Six<br/>Months Ended<br/>June 30, 2012</b> |
|-----------------------------|---|
| Expected volatility         | 77.2%   |
| Risk free interest rate     | 1.8%  |
| Expected dividends          | 1.0%  |
| Expected life (in years)    | 8.0   |
| Weighted average fair value | \$ 9.67   |

**Restricted Stock Awards and Units**

The table below presents the activity of restricted stock awards and units for the six months ended June 30, 2012:

|                              | Shares    | Weighted Average<br>Grant Date<br>Fair Value |
|------------------------------|-----------|--|
| Nonvested at January 1, 2012 | 1,015,304 | \$ 14.86                                     |
| Changes during the period:   |           |  |
| Granted                      | 260,153   | 14.26  |
| Vested                       | (195,236) | 15.70  |
| Forfeited                    | (40,841)  | 14.64  |
| Nonvested at June 30, 2012   | 1,039,380 | 14.56  |

**13. ACCUMULATED OTHER COMPREHENSIVE INCOME**

Components of accumulated other comprehensive income, net of taxes, were as follows:

|   | <b>June 30,<br/>2012</b> | <b>December 31,<br/>2011</b> |
|---|--------------------------|------------------------------|
|   | (Dollars in thousands)   |                              |
| Net unrealized gain on available for sale investment securities | \$ 22,227                | \$ 24,011                    |
| Net unrealized loss on derivatives                              | (11,490)                 | (10,559)                     |
| Pension adjustments   | (10,111)                 | (11,288)                     |
| Accumulated other comprehensive income, net of tax              | \$ 626                   | \$ 2,164                     |

**14. PENSION PLANS**

Central Pacific Bank 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:

|                                   | Three Months Ended<br>June 30, |        | Six Months Ended<br>June 30, |          |
|-----------------------------------|--------------------------------|--------|------------------------------|----------|
|                                   | 2012                           | 2011   | 2012                         | 2011     |
|                                   | (Dollars in thousands)         |        |                              |          |
| Interest cost                     | \$ 398                         | \$ 417 | \$ 796                       | \$ 834   |
| Expected return on assets         | (447)                          | (457)  | (894)                        | (914)    |
| Amortization of unrecognized loss | 581                            | 550    | 1,162                        | 1,100    |
| Net periodic cost                 | \$ 532                         | \$ 510 | \$ 1,064                     | \$ 1,020 |

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The fair values of the defined benefit retirement plan as of June 30, 2012 and December 31, 2011 by asset category were as follows:

|                                | Level 1                | Level 2  | Level 3 | Total     |
|--------------------------------|------------------------|----------|---------|-----------|
|                                | (Dollars in thousands) |          |         |           |
| <b>June 30, 2012</b>           |                        |          |         |           |
| Money market accounts          | \$ 1,488               | \$       | \$      | \$ 1,488  |
| Mutual funds                   | 454                    |          |         | 454       |
| Government obligations         |                        | 3,438    |         | 3,438     |
| Common stocks                  | 5,795                  |          |         | 5,795     |
| Exchange traded funds          | 9,018                  |          |         | 9,018     |
| Preferred stocks               | 247                    |          |         | 247       |
| Corporate bonds and debentures |                        | 3,086    |         | 3,086     |
|                                | \$ 17,002              | \$ 6,524 | \$      | \$ 23,526 |
| <b>December 31, 2011</b>       |                        |          |         |           |
| Money market accounts          | \$ 1,869               | \$       | \$      | \$ 1,869  |
| Mutual funds                   | 439                    |          |         | 439       |
| Government obligations         |                        | 3,264    |         | 3,264     |
| Common stocks                  | 5,376                  |          |         | 5,376     |
| Exchange traded funds          | 8,494                  |          |         | 8,494     |
| Preferred stocks               | 226                    |          |         | 226       |
| Corporate bonds and debentures |                        | 2,891    |         | 2,891     |
|                                | \$ 16,404              | \$ 6,155 | \$      | \$ 22,559 |

Our bank also established Supplemental Executive Retirement Plans ( SERPs ), which provide certain officers of our bank with supplemental retirement benefits. The following table sets forth the components of net periodic benefit cost for the SERPs:

|  | Three Months Ended<br>June 30, |        | Six Months Ended<br>June 30, |        |
|--|--------------------------------|--------|------------------------------|--------|
|  | 2012                           | 2011   | 2012                         | 2011   |
|  | (Dollars in thousands)         |        |                              |        |
| Service cost                                       | \$                             | \$     | \$                           | \$     |
| Interest cost                                      | 107                            | 103    | 214                          | 206    |
| Amortization of unrecognized transition obligation | 4                              | 4      | 8                            | 8      |
| Amortization of prior service cost                 | 5                              | 5      | 10                           | 10     |
| Amortization of unrecognized gain                  | (1)                            | (4)    | (2)                          | (8)    |
| Net periodic cost                                  | \$ 115                         | \$ 108 | \$ 230                       | \$ 216 |

**15. INCOME TAXES**

The valuation allowance for net deferred tax assets at June 30, 2012 and December 31, 2011 was \$155.1 million and \$162.3 million, respectively. The \$7.2 million decrease in our valuation allowance during the six months ended June 30, 2012 was attributable to a decrease in our net deferred tax assets resulting from the net operating income recognized in the six months ended June 30, 2012. In assessing the realizability of deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods

in which those temporary differences become deductible. Management considers the reversal of deferred tax liabilities (including the impact of available carryback and carryforward periods), projected future taxable income and tax-planning strategies in making this assessment. Based upon the Company's cumulative three year loss position and projections for future taxable income over the periods in which the deferred tax assets are deductible, management believes it is more likely than not that the Company will be unable to realize the benefits of these deductible differences. The amount of the net deferred tax asset considered realizable, however, could change if estimates of future taxable income during the carryforward period change.

Table of Contents**16. EARNINGS PER SHARE**

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

|  | Three Months Ended<br>June 30,        |          | Six Months Ended<br>June 30, |           |
|--|---------------------------------------|----------|------------------------------|-----------|
|  | 2012                                  | 2011     | 2012                         | 2011      |
|  | (In thousands, except per share data) |          |                              |           |
| Net income   | \$ 10,812                             | \$ 8,211 | \$ 24,290                    | \$ 12,850 |
| Preferred stock dividends, accretion of discount and conversion of preferred stock to common stock |                                       |          |                              | (83,897)  |
| Net income available to common shareholders  | \$ 10,812                             | \$ 8,211 | \$ 24,290                    | \$ 96,747 |
| Weighted average shares outstanding - basic  | 41,717                                | 40,700   | 41,674                       | 30,059    |
| Dilutive effect of employee stock options and awards   | 155                                   | 349      | 201                          | 648       |
| Dilutive effect of deferred salary restricted stock units  | 67                                    | 3        | 63                           | 2         |
| Dilutive effect of Treasury warrants   | 20                                    | 26       | 21                           | 24        |
| Weighted average shares outstanding - diluted  | 41,959                                | 41,078   | 41,959                       | 30,733    |
| Basic earnings per share   | \$ 0.26                               | \$ 0.20  | \$ 0.58                      | \$ 3.22   |
| Diluted earnings per share   | \$ 0.26                               | \$ 0.20  | \$ 0.58                      | \$ 3.15   |

A total of 345,125 potentially dilutive securities have been excluded from the dilutive share calculation for the three and six months ended June 30, 2012, as their effect was antidilutive, compared to 41,821 for the three and six months ended June 30, 2011.

**17. FAIR VALUE OF FINANCIAL ASSETS AND LIABILITIES****Disclosures about Fair Value of Financial Instruments**

Fair value estimates, methods and assumptions are set forth below for our financial instruments.

Short-Term Financial Instruments

The carrying values of short-term financial instruments are deemed to approximate fair values. Such instruments are considered readily convertible to cash and include cash and due from banks, interest-bearing deposits in other banks, accrued interest receivable, the majority of short-term borrowings and accrued interest payable.

Investment Securities

The fair value of investment securities is based on market price quotations received from securities dealers. Where quoted market prices are not available, fair values are based on quoted market prices of comparable securities.

Loans

Fair values of loans are estimated based on discounted cash flows of portfolios of loans with similar financial characteristics including the type of loan, interest terms and repayment history. Fair values are calculated by discounting scheduled cash flows through estimated maturities using estimated market discount rates. Estimated market discount rates are reflective of credit and interest rate risks inherent in the Company's various loan types and are derived from available market information, as well as specific borrower information. The fair value of loans are not based on the notion of exit price.

Loans Held for Sale

The fair value of loans classified as held for sale are generally based upon quoted prices for similar assets in active markets, acceptance of firm offer letters with agreed upon purchase prices, discounted cash flow models that take into account market observable assumptions, or independent appraisals of the underlying collateral securing the loans. We report the fair values of Hawaii and mainland construction and commercial real estate loans net of applicable selling costs on our consolidated balance sheets.

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Other Interest Earning Assets

The equity investment in common stock of the FHLB, which is redeemable for cash at par value, is reported at its par value.

Deposit Liabilities

The fair values of deposits with no stated maturity, such as noninterest-bearing demand deposits and interest-bearing demand and savings accounts, are equal to the amount payable on demand. The fair value of time deposits is estimated using discounted cash flow analyses. The discount rate is estimated using the rates currently offered for deposits of similar remaining maturities.

Short-Term Borrowings and Long-Term Debt

The fair value for a portion of our short-term borrowings is estimated by discounting scheduled cash flows using rates currently offered for securities of similar remaining maturities. The fair value of our long-term debt, primarily FHLB advances, is estimated by discounting scheduled cash flows over the contractual borrowing period at the estimated market rate for similar borrowing arrangements.

Off-Balance Sheet Financial Instruments

The fair values of off-balance sheet financial instruments are estimated based on the fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the present creditworthiness of the counterparties, current settlement values or quoted market prices of comparable instruments.

For derivative financial instruments, the fair values are based upon current settlement values, if available. If there are no relevant comparables, fair values are based on pricing models using current assumptions for interest rate swaps and options.

Limitations

Fair value estimates are made at a specific point in time based on relevant market information and information about the financial instrument. These estimates do not reflect any premium or discount that could result from offering for sale at one time our entire holdings of a particular financial instrument. Because no market exists for a significant portion of our financial instruments, fair value estimates are based on judgments regarding future expected loss experience, current economic conditions, risk characteristics of various financial instruments and other factors. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and therefore cannot be determined with



precision. Changes in assumptions could significantly affect the estimates.

Fair value estimates are based on existing on- and off-balance sheet financial instruments without attempting to estimate the value of future business and the value of assets and liabilities that are not considered financial instruments. For example, significant assets and liabilities that are not considered financial assets or liabilities include deferred tax assets, premises and equipment and intangible assets. In addition, the tax ramifications related to the realization of the unrealized gains and losses can have a significant effect on fair value estimates and have not been considered in many of the estimates.

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|  | Fair Value Measurement Using |                         |   |   |  |
|--|------------------------------|-------------------------|---|---|--|
|  | Carrying<br>amount           | Estimated<br>fair value | Quoted Prices in<br>Active Markets for<br>Identical Assets<br>(Level 1)<br>(Dollars in thousands) | Significant Other<br>Observable Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| <b>June 30, 2012</b>                                       |                              |                         |   |   |  |
| <b>Financial assets</b>                                    |                              |                         |   |   |  |
| Cash and due from banks                                    | \$ 72,967                    | \$ 72,967               | \$ 72,967   | \$  | \$   |
| Interest-bearing deposits in other banks                   | 100,544                      | 100,544                 | 100,544   |   |  |
| Investment securities                                      | 1,633,011                    | 1,633,019               | 869   | 1,619,271   | 12,879   |
| Loans held for sale  | 30,831                       | 30,831                  |   | 10,385  | 20,446   |
| Net loans and leases                                       | 1,997,349                    | 1,949,615               |   | 114,685   | 1,834,930  |
| Accrued interest receivable                                | 12,596                       | 12,596                  | 12,596  |   |  |
| <b>Financial liabilities</b>                               |                              |                         |   |   |  |
| Deposits:  |                              |                         |   |   |  |
| Noninterest-bearing deposits                               | 769,010                      | 769,010                 | 769,010   |   |  |
| Interest-bearing demand and savings deposits               | 1,787,679                    | 1,787,679               | 1,787,679   |   |  |
| Time deposits  | 1,005,628                    | 1,008,530               |   |   | 1,008,530  |
| Long-term debt   | 108,289                      | 37,008                  |   | 37,008  |  |
| Accrued interest payable (included in other liabilities)   | 11,412                       | 11,412                  | 11,412  |   |  |
| <b>Off-balance sheet financial instruments</b>             |                              |                         |   |   |  |
| Commitments to extend credit                               | 494,120                      | 2,471                   |   | 2,471   |  |
| Standby letters of credit and financial guarantees written | 12,877                       | 97                      |   | 97  |  |
| Interest rate options                                      | 135,265                      | 1,197                   |   | 1,197   |  |
| Forward interest rate contracts                            | 49,079                       | (365)                   |   | (365)   |  |
| <b>December 31, 2011</b>                                   |                              |                         |   |   |  |
| <b>Financial assets</b>                                    |                              |                         |   |   |  |
| Cash and due from banks                                    | \$ 76,233                    | \$ 76,233               | \$ 76,233   | \$  | \$   |
| Interest-bearing deposits in other banks                   | 180,839                      | 180,839                 | 180,839   |   |  |
| Investment securities                                      | 1,493,925                    | 1,493,970               | 970   | 1,480,006   | 12,994   |
| Loans held for sale  | 50,290                       | 50,290                  |   | 12,414  | 37,876   |
| Net loans and leases                                       | 1,942,354                    | 1,858,267               |   | 131,836   | 1,726,431  |
| Accrued interest receivable                                | 11,674                       | 11,674                  | 11,674  |   |  |
| <b>Financial liabilities</b>                               |                              |                         |   |   |  |
| Deposits:  |                              |                         |   |   |  |
| Noninterest-bearing deposits                               | 729,149                      | 729,149                 | 729,149   |   |  |
| Interest-bearing demand and savings deposits               | 1,705,551                    | 1,705,551               | 1,705,551   |   |  |
| Time deposits  | 1,008,828                    | 1,012,121               |   |   | 1,012,121  |
| Short-term borrowings                                      | 34                           | 34                      |   | 34  |  |
| Long-term debt   | 158,298                      | 89,646                  |   | 89,646  |  |
| Accrued interest payable (included in other liabilities)   | 10,019                       | 10,019                  | 10,019  |   |  |
| <b>Off-balance sheet financial instruments</b>             |                              |                         |   |   |  |

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|  |         |       |       |
|--|---------|-------|-------|
| Commitments to extend credit                               | 451,378 | 2,257 | 2,257 |
| Standby letters of credit and financial guarantees written | 13,159  | 99    | 99    |
| Interest rate options                                      | 68,979  | 515   | 515   |
| Forward interest rate contracts                            | 33,776  | (413) | (413) |
| Forward foreign exchange contracts                         | 547     | 1     | 1     |

**Fair Value Measurements**

We group our financial assets and liabilities at fair value into three levels based on the markets in which the financial assets and liabilities are traded and the reliability of the assumptions used to determine fair value as follows:

- Level 1 Valuation is based upon quoted prices (unadjusted) for identical assets or liabilities traded in active markets. A quoted price in an active market provides the most reliable evidence of fair value and shall be used to measure fair value whenever available.

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

We base our fair values on the price that we would expect to receive if an asset were sold or pay to transfer a liability in an orderly transaction between market participants at the measurement date. We also maximize the use of observable inputs and minimize the use of unobservable inputs when developing fair value measurements.

We use fair value measurements to record adjustments to certain financial assets and liabilities and to determine fair value disclosures. Available for sale securities and derivatives are recorded at fair value on a recurring basis. From time to time, we may be required to record other financial assets at fair value on a nonrecurring basis such as loans held for sale, impaired loans and mortgage servicing rights. These nonrecurring fair value adjustments typically involve application of the lower of cost or fair value accounting or write-downs of individual assets.

There were no transfers of financial assets and liabilities between Level 1 and Level 2 of the fair value hierarchy during the three and six months ended June 30, 2012.

The following table presents the balances of assets and liabilities measured at fair value on a recurring basis as of June 30, 2012 and December 31, 2011:

|  | Fair Value | Fair Value at Reporting Date Using  |   |  |
|--|------------|---|---|--|
|  |            | Quoted Prices<br>in Active<br>Markets for<br>Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| (Dollars in thousands)   |            |   |   |  |
| <b>June 30, 2012</b>   |            |   |   |  |
| Available for sale securities:                                   |            |   |   |  |
| U.S. Government sponsored entities<br>debt securities            | \$ 357,293 | \$  | \$ 357,293  | \$   |
| States and political subdivisions debt<br>securities             | 92,524     |   | 79,645  | 12,879   |
| U.S. Government sponsored entities<br>mortgage-backed securities | 1,132,850  |   | 1,132,850   |  |
| Corporate securities   | 48,988     |   | 48,988  |  |
| Other  | 869        | 869   |   |  |
| Derivatives:   |            |   |   |  |

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|                         |              |        |              |           |
|-------------------------|--------------|--------|--------------|-----------|
| Interest rate contracts | 831          |        | 831          |           |
| Amended TARP Warrant    | (785)        |        | (785)        |           |
| Total                   | \$ 1,632,570 | \$ 869 | \$ 1,618,822 | \$ 12,879 |

**December 31, 2011**

Available for sale securities:

|  |            |    |            |    |
|--|------------|----|------------|----|
| U.S. Government sponsored entities debt securities | \$ 373,177 | \$ | \$ 373,177 | \$ |
|--|------------|----|------------|----|

|   |        |  |  |        |
|---|--------|--|--|--------|
| States and political subdivisions debt securities | 12,994 |  |  | 12,994 |
|---|--------|--|--|--------|

|   |           |  |           |  |
|---|-----------|--|-----------|--|
| U.S. Government sponsored entities mortgage-backed securities | 1,097,302 |  | 1,097,302 |  |
|---|-----------|--|-----------|--|

|                      |       |  |       |  |
|----------------------|-------|--|-------|--|
| Corporate securities | 8,551 |  | 8,551 |  |
|----------------------|-------|--|-------|--|

|       |     |     |  |  |
|-------|-----|-----|--|--|
| Other | 970 | 970 |  |  |
|-------|-----|-----|--|--|

Derivatives:

|                         |     |  |     |  |
|-------------------------|-----|--|-----|--|
| Interest rate contracts | 102 |  | 102 |  |
|-------------------------|-----|--|-----|--|

|                      |       |  |       |  |
|----------------------|-------|--|-------|--|
| Amended TARP Warrant | (677) |  | (677) |  |
|----------------------|-------|--|-------|--|

|       |              |        |              |           |
|-------|--------------|--------|--------------|-----------|
| Total | \$ 1,492,419 | \$ 970 | \$ 1,478,455 | \$ 12,994 |
|-------|--------------|--------|--------------|-----------|

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For the six months ended June 30, 2012 and 2011, the changes in Level 3 assets and liabilities measured at fair value on a recurring basis are summarized as follows:

|  | Available for<br>sale states and<br>political<br>subdivisions<br>debt securities | Available for sale<br>non-agency<br>collateralized<br>mortgage<br>obligations (1) |           |
|--|--|---|-----------|
|  | (Dollars in thousands)   |   |           |
| Balance at December 31, 2011                               | \$ 12,994  | \$  |           |
| Principal payments received                                | (189)  |   |           |
| Unrealized net gain included in other comprehensive income | 74   |   |           |
| <b>Balance at June 30, 2012</b>                            | <b>\$ 12,879</b>   | <b>\$</b>   |           |
| Balance at December 31, 2010                               | \$ 12,619  | \$  | 17        |
| Principal payments received                                | (176)  |   |           |
| <b>Balance at June 30, 2011</b>                            | <b>\$ 12,443</b>   | <b>\$</b>   | <b>17</b> |

(1) Represents available for sale non-agency collateralized mortgage obligations previously classified as Level 2 for which the market became inactive during 2008; therefore the fair value measurement was derived from discounted cash flow models using unobservable inputs and assumptions.

Within the state and political subdivisions debt securities category, the Company holds four mortgage revenue bonds issued by the City & County of Honolulu with an aggregate fair value of \$12.9 million. The Company estimates the fair value of its mortgage revenue bonds by using a discounted cash flow model to calculate the present value of estimated future principal and interest payments.

The significant unobservable input used in the fair value measurement of the Company's mortgage revenue bonds is the weighted average discount rate. As of June 30, 2012, the weighted average discount rate utilized was 2.71%, which was derived by incorporating a credit spread over the FHLB Fixed-Rate Advance curve. Significant increases (decreases) in the weighted average discount rate could result in a significantly lower (higher) fair value measurement.

For assets measured at fair value on a nonrecurring basis that were recorded at fair value on our balance sheet at June 30, 2012 and December 31, 2011, the following table provides the level of valuation assumptions used to determine the respective fair values:

| Fair Value | Fair Value Measurements Using   |   | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
|------------|---|---|--|
|            | Quoted Prices in<br>Active Markets for<br>Identical Assets<br>(Level 1) | Significant Other<br>Observable Inputs<br>(Level 2) |  |
|            | (Dollars in thousands)  |   |  |

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**June 30, 2012**

|                         |    |         |    |    |         |    |
|-------------------------|----|---------|----|----|---------|----|
| Loans held for sale (1) | \$ | 10,385  | \$ | \$ | 10,385  | \$ |
| Impaired loans (1)      |    | 114,685 |    |    | 114,685 |    |
| Other real estate (2)   |    | 49,379  |    |    | 49,379  |    |

**December 31, 2011**

|                         |    |         |    |    |         |    |
|-------------------------|----|---------|----|----|---------|----|
| Loans held for sale (1) | \$ | 12,414  | \$ | \$ | 12,414  | \$ |
| Impaired loans (1)      |    | 131,836 |    |    | 131,836 |    |
| Other real estate (2)   |    | 61,681  |    |    | 61,681  |    |

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(1) Represents carrying value and related write-downs of loans for which adjustments are based on agreed upon purchase prices for the loans or the appraised value of the collateral.

(2) Represents other real estate that is carried at the lower of carrying value or fair value less costs to sell. Fair value is generally based upon independent market prices or appraised values of the collateral.

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**18. SEGMENT INFORMATION**

Due to recent changes in our organizational structure, in the first quarter of 2012, we changed our reportable segments to better align our segments with how management reviews and monitors the performance of the Company's financial results. We now have the following three reportable segments: Banking Operations, Treasury and All Others. These segments are consistent with our internal functional reporting lines and are managed separately because each unit has different target markets, technological requirements, marketing strategies and specialized skills.

The Banking Operations segment includes construction and real estate development lending, commercial lending, residential mortgage lending and servicing, indirect auto lending, trust services, retail brokerage services and our retail branch offices, which provide a full range of deposit and loan products, as well as various other banking services. The Treasury segment is responsible for managing the Company's investment securities portfolio and wholesale funding activities. The All Others segment consists of all activities not captured by the Banking Operations or Treasury segments described above and 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, 2011 filed with the SEC. 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 leases 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.



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

|  | Banking<br>Operations | Treasury<br>(Dollars in thousands) | All Others  | Total     |
|--|-----------------------|------------------------------------|-------------|-----------|
| <b>Three months ended June 30, 2012:</b>       |                       |                                    |             |           |
| Net interest income                            | \$ 22,994             | \$ 7,265                           | \$          | \$ 30,259 |
| Intersegment net interest income (expense)     | 10,059                | (5,111)                            | (4,948)     |           |
| Credit for loan and lease losses               | 6,630                 |                                    |             | 6,630     |
| Other operating income                         | 12,365                | 1,452                              | (203)       | 13,614    |
| Other operating expense                        | (21,677)              | (500)                              | (17,514)    | (39,691)  |
| Administrative and overhead expense allocation | (16,771)              | (266)                              | 17,037      |           |
| Net income (loss)                              | \$ 13,600             | \$ 2,840                           | \$ (5,628)  | \$ 10,812 |
| <b>Three months ended June 30, 2011:</b>       |                       |                                    |             |           |
| Net interest income                            | \$ 23,305             | \$ 5,674                           | \$          | \$ 28,979 |
| Intersegment net interest income (expense)     | 11,084                | (5,074)                            | (6,010)     |           |
| Credit for loan and lease losses               | 8,784                 |                                    |             | 8,784     |
| Other operating income                         | 8,892                 | 1,704                              | 341         | 10,937    |
| Other operating expense                        | (26,460)              | (138)                              | (13,891)    | (40,489)  |
| Administrative and overhead expense allocation | (13,050)              | (127)                              | 13,177      |           |
| Net income (loss)                              | \$ 12,555             | \$ 2,039                           | \$ (6,383)  | \$ 8,211  |
| <b>Six months ended June 30, 2012:</b>         |                       |                                    |             |           |
| Net interest income                            | \$ 46,231             | \$ 14,530                          | \$          | \$ 60,761 |
| Intersegment net interest income (expense)     | 22,475                | (10,968)                           | (11,507)    |           |
| Credit for loan and lease losses               | 11,620                |                                    |             | 11,620    |
| Other operating income                         | 24,701                | 2,538                              | (393)       | 26,846    |
| Other operating expense                        | (43,521)              | (898)                              | (30,518)    | (74,937)  |
| Administrative and overhead expense allocation | (29,525)              | (462)                              | 29,987      |           |
| Net income (loss)                              | \$ 31,981             | \$ 4,740                           | \$ (12,431) | \$ 24,290 |
| <b>Six months ended June 30, 2011:</b>         |                       |                                    |             |           |
| Net interest income                            | \$ 47,729             | \$ 9,451                           | \$          | \$ 57,180 |
| Intersegment net interest income (expense)     | 21,510                | (6,297)                            | (15,213)    |           |
| Credit for loan and lease losses               | 10,359                |                                    |             | 10,359    |
| Other operating income                         | 19,267                | 3,343                              | 827         | 23,437    |
| Other operating expense                        | (51,906)              | (227)                              | (25,993)    | (78,126)  |
| Administrative and overhead expense allocation | (24,752)              | (252)                              | 25,004      |           |
| Net income (loss)                              | \$ 22,207             | \$ 6,018                           | \$ (15,375) | \$ 12,850 |
| <b>At June 30, 2012:</b>                       |                       |                                    |             |           |

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|  |    |           |    |           |    |        |    |           |
|--|----|-----------|----|-----------|----|--------|----|-----------|
| Investment securities                            | \$ |           | \$ | 1,633,011 | \$ |        | \$ | 1,633,011 |
| Loans and leases (including loans held for sale) |    | 2,131,994 |    |           |    |        |    | 2,131,994 |
| Other  |    | 24,527    |    | 348,556   |    | 88,982 |    | 462,065   |
| Total assets                                     | \$ | 2,156,521 | \$ | 1,981,567 | \$ | 88,982 | \$ | 4,227,070 |

**At December 31, 2011:**

|  |    |           |    |           |    |        |    |           |
|--|----|-----------|----|-----------|----|--------|----|-----------|
| Investment securities                            | \$ |           | \$ | 1,493,925 | \$ |        | \$ | 1,493,925 |
| Loans and leases (including loans held for sale) |    | 2,114,737 |    |           |    |        |    | 2,114,737 |
| Other  |    | 23,858    |    | 429,141   |    | 71,204 |    | 524,203   |
| Total assets                                     | \$ | 2,138,595 | \$ | 1,923,066 | \$ | 71,204 | \$ | 4,132,865 |

**19. LEGAL PROCEEDINGS**

We are involved in legal actions arising in the ordinary course of business. Management, after consultation with our legal counsel, believes the ultimate disposition of those matters will not have a material adverse effect on our consolidated financial statements.

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

**Overview**

Central Pacific Financial Corp. ( CPF ) is a Hawaii corporation and a bank holding company. Our principal business is to serve as a holding company for our bank subsidiary, Central Pacific Bank. We refer to Central Pacific Bank herein as our bank or the bank, and when we say the Company, we, us or our, we mean the holding company on a consolidated basis with the bank and our other consolidated subsidiaries.

Central Pacific Bank is a full-service community bank with 34 branches and 117 ATMs located throughout the state of Hawaii. The bank offers a broad range of products and services including accepting time and demand deposits and originating loans, including commercial loans, construction loans, commercial and residential mortgage loans, and consumer loans.

**Regulatory Actions**

As previously reported, in May 2011, the regulatory Consent Order (the Consent Order ) that the bank entered into with the Federal Deposit Insurance Corporation (the FDIC ) and the Hawaii Division of Financial Institutions (the DFI ) on December 9, 2009 was lifted. In place of the Consent Order, the Board of Directors of the bank entered into a Memorandum of Understanding (the Bank MOU ) with the FDIC and DFI effective May 5, 2011. The Bank MOU continues a number of the same requirements previously required by the Consent Order, including the maintenance of an adequate allowance for loan and lease losses, improvement of our asset quality, limitations on credit extensions, maintenance of qualified management and the prohibition on cash dividends to CPF, among other matters. In addition, the Bank MOU requires the bank to further reduce classified assets below the level previously required by the Consent Order. The Bank MOU lowers the minimum leverage capital ratio that the bank is required to maintain from 10% in the Consent Order to 8% and does not mandate a minimum total risk-based capital ratio.

In addition to the Bank MOU, the Company continues to be subject to a Written Agreement (the Written Agreement ) with the Federal Reserve Bank of San Francisco (the FRBSF ) and DFI dated July 2, 2010, which superseded in its entirety the Memorandum of Understanding that the Company entered into on April 1, 2009 with the FRBSF and DFI. Among other matters, the Written Agreement provides that unless we receive the consent of the FRBSF and DFI, we cannot: (i) pay dividends; (ii) receive dividends or payments representing a reduction in capital from the bank; (iii) directly or through our non-bank subsidiaries make any payments on subordinated debentures or trust preferred securities; (iv) directly or through any non-bank subsidiaries incur, increase or guarantee any debt; or (v) purchase or redeem any shares of our stock. The Written Agreement requires that our Board of Directors fully utilize the Company's financial and managerial resources to ensure that the bank complies with the Bank MOU and any other supervisory action taken by the bank's regulators. We were also required to submit to the FRBSF an acceptable capital plan and cash flow projection.

Even though the Consent Order has been replaced by the Bank MOU, the bank remains subject to a number of requirements as described above. We believe that we are in compliance in all material respects with the material terms of the Bank MOU and the Written Agreement and are meeting the timeline for compliance set out in such agreements subject to our continuing efforts to improve core earnings and reduce the level of our nonperforming assets. However, we cannot assure you whether or when the Company and the bank will be in full compliance with the agreements with the regulators or whether or when the Bank MOU or the Written Agreement will be terminated. Even if terminated, we may still be subject to other agreements with regulators that restrict our activities and may also continue to impose capital ratios or other requirements

on our business. The requirements and restrictions of the Bank MOU and the Written Agreement are judicially enforceable and the Company or the bank's failure to comply with such requirements and restrictions may subject the Company and the bank to additional regulatory restrictions including: the imposition of a new consent order; the imposition of civil monetary penalties; the termination of insurance of deposits; the issuance of removal and prohibition orders against institution-affiliated parties; the appointment of a conservator or receiver for the bank; the issuance of directives to increase capital or enter into a strategic transaction, whether by merger or otherwise, with a third party, if we again fall below the capital ratio requirements; and the enforcement of such actions through injunctions or restraining orders.

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**Recovery Plan Progress**

As previously disclosed, we adopted and implemented a recovery plan in March 2010 to improve our financial health by completing a significant recapitalization, reducing our credit risk exposure and returning to profitability by focusing on our core businesses and traditional markets in Hawaii.

Through June 30, 2012, we accomplished a number of key milestones in our recovery plan, including:

- On February 2, 2011, we effected a one-for-twenty reverse stock split of our common stock (the Reverse Stock Split ).
  
- On February 18, 2011, we successfully completed a \$325 million capital raise (the Private Placement ). Concurrently with the completion of the Private Placement, we exchanged our Troubled Assets Relief Program ( TARP ) preferred stock and accrued and unpaid dividends thereon for common stock (the TARP Exchange ).
  
- On May 6, 2011, we successfully completed a \$20 million Rights Offering (the Rights Offering ).
  
- In May 2011, the Consent Order was lifted and replaced with the Bank MOU.
  
- We improved our tier 1 risk-based capital, total risk-based capital, and leverage capital ratios as of June 30, 2012 to 23.04%, 24.32%, and 14.12%, respectively, from 22.48%, 23.80%, and 13.13%, respectively, as of June 30, 2011. Our capital ratios continue to exceed the minimum levels required by both the Bank MOU and the levels required for a well-capitalized regulatory designation.
  
- Maintained positive momentum from our turnaround in 2011 as we reported a sixth consecutive profitable quarter with net income of \$10.8 million in the second quarter of 2012 and \$4.6 million, \$8.2 million, \$11.6 million, \$12.1 million and \$13.5 million in the first, second, third and fourth quarters of 2011, and the first quarter of 2012, respectively.
  
- We had \$40,000 in outstanding borrowings with the Federal Home Loan Bank of Seattle (the FHLB ) at June 30, 2012 compared to \$50.0 million at December 31, 2011.

We intend to continue to execute on our recovery plan and focus on, among other things, improving our asset quality, increasing profitability from our banking operations, enhancing our cross-selling of products and services to our customers, improving our efficiency ratio and operating efficiencies and effectively competing in the Hawaii market.

#### **Basis of Presentation**

Management's discussion and analysis of financial condition and results of operations should be read in conjunction with the accompanying consolidated financial statements under Part I, Item 1. Financial Statements (Unaudited). The following discussion should also be read in conjunction with the Company's Annual Report on Form 10-K for the year ended December 31, 2011 filed with the U.S. Securities and Exchange Commission (the "SEC") on February 29, 2012.

#### **Critical Accounting Policies**

The preparation of financial statements in accordance with accounting principles generally accepted in the United States of America ("GAAP") 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.

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Allowance for Loan and Lease Losses

The allowance for loan and lease losses (the Allowance) is management's estimate of credit losses inherent in our loan and lease portfolio at the balance sheet date. We maintain our Allowance at an amount we expect to be sufficient to absorb probable losses inherent in our loan and lease portfolio based on a projection of probable net loan charge-offs.

For loans classified as impaired, an estimated impairment loss is calculated. To estimate 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, including the real estate market generally and the residential and commercial construction markets in particular. Estimated loss rates are determined by loan category and risk profile, and an overall required Allowance is calculated, which includes amounts for imprecision and uncertainty. Based on our estimate of the level of Allowance required, a provision for loan and lease losses (the Provision) is recorded to maintain the Allowance at an appropriate level.

Our policy is to charge a loan off in the period in which the loan is deemed to be uncollectible. We consider a loan to be uncollectible when it is probable that a loss has been incurred and the Company can make a reasonable estimate of the loss. In these instances, the likelihood of and/or timeframe for recovery of the amount due is uncertain, weak, or protracted.

Our process for determining the reserve for unfunded commitments is consistent with our process for determining the Allowance and is adjusted for estimated loan funding probabilities. Reserves for unfunded commitments are recorded separately through a valuation allowance included in other liabilities. Credit losses for off-balance sheet credit exposures are deducted from the allowance for credit losses on off-balance sheet credit exposures in the period in which the liability is settled. The allowance for credit losses on off-balance sheet credit losses is established by a charge to other operating expense.

In the second quarter of 2012, we recorded a credit to the Provision of \$6.6 million. We had an Allowance as a percentage of total loans and leases of 4.94% at June 30, 2012, compared to 5.91% at December 31, 2011. Although other factors of our overall risk profile have improved in recent quarters and general economic trends and market conditions have shown signs of stabilization to some degree, as further described in the Material Trends section below, concerns over the global and U.S. economies still remain. Accordingly, it is possible that the Hawaii or California real estate markets could begin to deteriorate further. If this occurs, it would result in an increase in loan delinquencies, an increase in loan charge-offs or a need for additional increases in our Allowance. Even if economic conditions improve or stay the same, it is possible that we may experience material credit losses and in turn, increases to our Allowance and Provision, due to the elevated risk still inherent in our existing loan portfolio resulting from our high concentration of commercial real estate and construction loans.

Additionally, when establishing our Allowance, we make certain assumptions and judgments with respect to the quality of our loan portfolio. As the economy began to deteriorate in the second half of 2007 and real estate values declined, we found that many of the assumptions and judgments that we made at the time needed to be materially changed in subsequent periods, which resulted in rapid negative credit migration and substantial losses in fiscal years 2008 through 2010. Because of the potential volatility that still exists in the marketplace, we are not able to predict the potential increases that we may need to incur in our Allowance if real estate values do not improve or continue to decline in the markets that we serve, or if the financial condition of our borrowers declines as a result of their continued exposure to the real estate markets and other financial stresses.

Since we cannot predict with certainty the amount of loan and lease charge-offs that will be incurred and because the eventual level of loan and lease charge-offs are impacted by numerous conditions beyond our control, we use our historical loss experience adjusted for current conditions to determine the Allowance and Provision. In addition, various regulatory agencies, as an integral part of their examination processes, periodically review our Allowance. The determination of the Allowance requires us to make estimates of losses that are highly uncertain and involves a high degree of judgment. Accordingly, actual results could differ from those estimates. Changes in the estimate of the Allowance and related Provision could materially affect our operating results.



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Loans Held for Sale

Loans held for sale consists of the following two types: (1) Hawaii residential mortgage loans that are originated with the intent to sell them in the secondary market and (2) Hawaii and Mainland construction and commercial real estate loans that were originated with the intent to be held in our portfolio but were subsequently transferred to the held for sale category. Hawaii residential mortgage loans classified as held for sale are carried at the lower of cost or fair value on an aggregate basis while the Hawaii and Mainland construction and commercial real estate loans are recorded at the lower of cost or fair value on an individual basis.

When a construction or commercial real estate loan is transferred to the held for sale category, the loan is recorded at the lower of cost or fair value. Any reduction in the loan's value is reflected as a write-down of the recorded investment resulting in a new cost basis, with a corresponding reduction in the Allowance. In subsequent periods, if the fair value of a loan classified as held for sale is less than its cost basis, a valuation adjustment is recognized in our consolidated statement of income in other operating expense and the carrying value of the loan is adjusted accordingly. The valuation adjustment may be recovered in the event that the fair value increases, which is also recognized in our consolidated statement of income in other operating expense.

The fair value of loans classified as held for sale are generally based upon quoted prices for similar assets in active markets, acceptance of firm offer letters with agreed upon purchase prices, discounted cash flow models that take into account market observable assumptions, or independent appraisals of the underlying collateral securing the loans. We report the fair values of Hawaii and mainland construction and commercial real estate loans net of applicable selling costs on our consolidated balance sheets.

Reserve for Residential Mortgage Loan Repurchase Losses

We sell residential mortgage loans on a whole-loan basis to government-sponsored entities ( GSEs or Agencies ) Fannie Mae and Freddie Mac and also to non-agency investors. These loan sales occur under industry standard contractual provisions that include various representations and warranties, which typically cover ownership of the loan, compliance with loan criteria set forth in the applicable agreement, validity of the lien securing the loan, and other similar matters. We may be required to repurchase certain loans sold with identified defects, indemnify the investor, or reimburse the investor for any credit losses incurred. We establish mortgage repurchase reserves related to various representations and warranties that reflect management's estimate for which we could have repurchase obligations. The reserves are established by a charge to other operating expense in our consolidated statements of operation. At June 30, 2012 and December 31, 2011, this reserve totaled \$5.8 million and \$6.8 million, respectively, and is included in other liabilities on our consolidated balance sheets.

The repurchase reserve is applicable to loans we originated and sold with representations and warranties, which is representative of the entire sold portfolio. Originations for agency and non-agency for vintages 2005 through June 30, 2012 were approximately \$3.7 billion and \$3.1 billion, respectively. Representations and warranties relating to borrower fraud generally are enforceable for the life of the loan, whereas early payment default clauses generally expire after 90 days, depending on the sales contract. We estimate that outstanding loans sold that have early payment default clauses as of June 30, 2012 total approximately \$110.1 million.

The repurchase loss liability is estimated by origination year to capture certain characteristics of each vintage. To the extent that repurchase demands are made by investors, we may be able to successfully appeal such repurchase demands. However, our appeals success may be affected

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by the reasons for repurchase demands, the quality of the demands, and our appeals strategies. Repurchase and loss estimates are stratified by vintage, based on actual experience and certain assumptions relative to potential investor demand volume, appeals success rates, and losses recognized on successful repurchase demands.

Loans repurchased during the three and six months ended June 30, 2012 totaled approximately \$1.0 million and \$2.6 million, respectively. In the first half of 2012, additional reserves were established to account for potential losses resulting from the recent emergence of make-whole demands. While our historical losses from make-whole demands are limited, based on recent investor requests, additional make-whole demands are anticipated and the establishment of additional reserves considers the potential for future losses related to this risk.

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Repurchase activity by vintage and investor type are depicted in the table below.

**Repurchase Demands, Appeals Granted, Repurchased and Pending Resolution [1]**

For the six months ended June 30, 2012

| Vintage        | Government Sponsored Entities ( GSE ) |                 |             |                    | Non-GSE Investors  |                 |             | Pending Resolution |
|----------------|---------------------------------------|-----------------|-------------|--------------------|--------------------|-----------------|-------------|--------------------|
|                | Repurchase Demands                    | Appeals Granted | Repurchased | Pending Resolution | Repurchase Demands | Appeals Granted | Repurchased |                    |
| 2005 and prior |                                       |                 |             |                    |                    |                 |             |                    |
| 2006           | 2                                     |                 | 1           | 1                  | 1                  | 1               |             |                    |
| 2007           | 2                                     | 1               |             |                    | 1                  |                 |             | 1                  |
| 2008           | 2                                     | 2               |             |                    | 2                  |                 |             | 2                  |
| 2009           |                                       |                 |             |                    |                    |                 |             |                    |
| 2010           | 1                                     |                 |             |                    | 1                  |                 |             |                    |
| 2011           | 5                                     | 3               | 1           | 1                  |                    |                 |             |                    |
| 2012           | 1                                     |                 | 1           |                    |                    |                 |             |                    |
| Total          | 13                                    | 6               | 3           | 4                  | 4                  | 1               |             | 3                  |

[1] Based on repurchase requests received between January 1, 2012 and June 30, 2012.

The reserve for residential mortgage loan repurchase losses of \$5.8 million at June 30, 2012 represents our best estimate of the probable loss that we may incur due to the representations and warranties in our loan sales contracts with investors. This represents a decrease of \$1.0 from December 31, 2011. The table below shows changes in the repurchase losses liability since initial establishment.

|                              | Six Months Ended June 30, |          | Year Ended December 31, |          |        |
|------------------------------|---------------------------|----------|-------------------------|----------|--------|
|                              | 2012                      | 2011     | 2011                    | 2010     | 2009   |
|                              | (Dollars in thousands)    |          |                         |          |        |
| Balance, beginning of period | \$ 6,802                  | \$ 5,014 | \$ 5,014                | \$ 183   | \$ 22  |
| Change in estimate           | (158)                     | 2,840    | 5,065                   | 6,071    | 161    |
| Utilizations                 | (838)                     | (1,198)  | (3,277)                 | (1,240)  |        |
| Balance, end of period       | \$ 5,806                  | \$ 6,656 | \$ 6,802                | \$ 5,014 | \$ 183 |

Our capacity to estimate repurchase losses is advancing as we record additional experience. Repurchase losses depend upon economic factors and other external conditions that may change over the life of the underlying loans. Additionally, lack of access to the servicing records of loans sold on a service released basis adds difficulty to the estimation process, thus requiring considerable management judgment. To the extent that future investor repurchase demand and appeals success differ from past experience, we could have increased demands and increased loss severities on repurchases, causing future additions to the repurchase reserve.

Other Intangible Assets

Other intangible assets include a core deposit premium, mortgage servicing rights, customer relationships and non-compete agreements. We perform an impairment assessment of our other intangible assets whenever events or changes in circumstance indicate that the carrying value of those assets may not be recoverable. Our impairment assessments involve, among other valuation methods, the estimation of future cash flows and other methods of determining fair value. Estimating future cash flows and determining fair values is subject to judgment and often involves the use of significant estimates and assumptions. The variability of the factors we use to perform our impairment tests depend on a number of conditions, including the uncertainty about future events and cash flows. All such factors are interdependent and, therefore, do not change in isolation. Accordingly, our accounting estimates may materially change from period to period due to changing market factors.

During the second quarter of 2012, we evaluated the recoverability of the intangible assets related to our customer relationships and non-compete agreements. Upon completion of this review, we determined that the intangible assets related to our customer relationships and non-compete agreements were both fully impaired, and thus, we recorded impairment charges to other operating expense totaling \$0.9 million during the second quarter of 2012.

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Deferred Tax Assets and Tax Contingencies

Deferred tax assets ( DTAs ) 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 DTAs 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 DTAs may not be realized, which would result in a charge to earnings. In 2009, we established a full valuation allowance against our net DTAs. See Results of Operations Income Taxes below.

We have established income tax contingency reserves for potential tax liabilities related to uncertain tax positions. Tax benefits are recognized when we determine that it is more likely than not that such benefits will be realized. Where uncertainty exists due to the complexity of income tax statutes and where the potential tax amounts are significant, we generally seek independent tax opinions to support our positions. If our evaluation of the likelihood of the realization of benefits is inaccurate, we could incur additional income tax and interest expense that would adversely impact earnings, or we could receive tax benefits greater than anticipated which would positively impact earnings.

Defined Benefit Retirement Plan

Defined benefit plan obligations and related assets of our defined benefit retirement plan are presented in Note 14 to the consolidated financial statements. In 2002, the defined benefit retirement plan was curtailed and all plan benefits were fixed as of that date. 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, 2011, we used a weighted-average discount rate of 4.8% and an expected long-term rate of return on plan assets of 8.0%, which affected the amount of pension liability recorded as of year-end 2011 and the amount of pension expense to be recorded in 2012. 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.

An increase in the discount rate or asset return rate would reduce pension expense in 2012, while a decrease in the discount rate or asset return rate would have the opposite effect. A 0.25% change in the discount rate assumption would impact 2012 pension expense by less than \$0.1 million and year-end 2011 pension liability by \$0.9 million, while a 0.25% change in the asset return rate would impact 2012 pension expense by less than \$0.1 million.

**Impact of Recently Issued Accounting Pronouncements on Future Filings**

In December 2011, the FASB issued ASU 2011-11, *Disclosures About Offsetting Assets and Liabilities*. ASU 2011-11 expands the disclosure requirements for financial instruments and derivatives that may be offset in accordance with enforceable master netting agreements or similar arrangements. The disclosures are required regardless of whether the instruments have been offset (or netted) in the balance sheet. Under ASU 2011-11, companies must describe the nature of offsetting arrangements and provide quantitative information about those agreements, including the gross and net amounts of financial instruments that are recognized in the balance sheet. ASU 2011-11 is effective for the Company's reporting period beginning on January 1, 2013, with retrospective application required. We do not expect the adoption of this guidance to have a material impact on our consolidated financial statements.

### **Financial Summary**

During the second quarter of 2012, we reported net income of \$10.8 million, or \$0.26 per diluted share, compared to \$8.2 million, or \$0.20 per diluted share, reported in the second quarter of 2011. Net income for the first half of 2012 was \$24.3 million, or \$0.58 per diluted share, compared to \$12.9 million, or \$3.15 per diluted share for the first half of 2011. Our net income per diluted share for the first half of 2011 included the impact of a one-time accounting adjustment totaling \$85.1 million related to the previously mentioned TARP Exchange.

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Our net income in the three and six months ended June 30, 2012 was driven by a significant reduction in our total credit costs as we experienced continued improvement in our credit risk profile. Total credit costs, which includes the Provision, write-downs of loans classified as held for sale, write-downs of foreclosed property and the change in the reserve for unfunded commitments, amounted to credits of \$5.6 million and \$10.6 million in the three and six months ended June 30, 2012, respectively, compared to credits of \$6.8 million and \$5.2 million in the three and six months ended June 30, 2011, respectively.

The following table presents annualized returns on average assets, average shareholders' equity, average tangible equity and basic and diluted earnings per share for the periods indicated. Average tangible equity is calculated as average shareholders' equity less average intangible assets, which includes goodwill, core deposit premium, customer relationships and non-compete agreements. Average intangible assets were \$18.0 million and \$18.4 million for the three and six months ended June 30, 2012, respectively, and \$20.9 million and \$21.3 million for the comparable prior year periods.

|  | Three Months Ended<br>June 30, |         | Six Months Ended<br>June 30, |          |
|--|--------------------------------|---------|------------------------------|----------|
|  | 2012                           | 2011    | 2012                         | 2011     |
| Return on average assets                 | 1.04%                          | 0.81%   | 1.18%                        | 0.64%    |
| Return on average shareholders<br>equity | 9.12                           | 8.08    | 10.37                        | 8.48     |
| Return on average tangible equity        | 9.48                           | 8.52    | 10.80                        | 9.12     |
| Basic earnings per common share          | \$ 0.26                        | \$ 0.20 | \$ 0.58                      | \$ 3.22* |
| Diluted earnings per common<br>share     | 0.26                           | 0.20    | 0.58                         | 3.15*    |

\* Includes the impact of a one-time accounting adjustment totaling \$85.1 million related to the TARP Exchange.

**Material Trends**

While there remains continued uncertainty in the global macroeconomic environment, the U.S. economy has continued to show signs of stabilization following the economic downturn caused by disruptions in the financial system in 2008.

Despite recent signs of stabilization, concerns about the global and U.S. economies still remain, including concerns over the European sovereign debt crisis. Growing U.S. government indebtedness, a large budget deficit, and concerns over the federal debt ceiling continue to add to the uncertainty surrounding a sustained economic recovery. In addition, downgrades in United States and foreign debt instruments could raise borrowing costs and adversely impact the mortgage and housing markets.

The majority of our operations are concentrated in the state of Hawaii. As a result, our performance is significantly influenced by conditions in the banking industry, macro economic conditions and the real estate markets in Hawaii. A favorable business environment is generally characterized by expanding gross state product, low unemployment and rising personal income; while an unfavorable business environment is characterized by declining gross state product, high unemployment and declining personal income.

According to the Hawaii Department of Business Economic Development & Tourism ( DBEDT ), based on the recent developments in the national and global economy, the performance of Hawaii's tourism industry, the labor market conditions in the state, and growth of personal income and tax revenues, Hawaii's economy is expected to continue positive growth for the rest of 2012 and into 2013. Tourism continues to be Hawaii's center of strength and its most significant economic driver. Hawaii's visitor industry is expected to break all records for arrivals and visitor spending this year. According to the Hawaii Tourism Authority ( HTA ), 3.9 million visitors visited the state in the first half of 2012. This was an increase of 10.2% from the number of visitor arrivals in the first half of 2011, with growth from all visitor markets. The HTA also reported that total visitor spending increased to \$7.11 billion in the first half of 2012, an increase of \$1.25 billion, or 21.4%, from the first half of 2011. According to a report from the University of Hawaii Economic Research Organization, total visitor arrivals and visitor spending are expected to gain 9.3% and 15.7% in 2012, respectively.

The Department of Labor and Industrial Relations reported that Hawaii's seasonally adjusted annual unemployment rate improved to 6.4% in June 2012, compared to 6.7% in June 2011. In addition, Hawaii's unemployment rate in June 2012 of 6.4% remained below the national seasonally adjusted unemployment rate of 8.2%. DBEDT projects real personal income and real gross state product to grow by 1.7% and 2.2%, respectively, in 2012.



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Historically, real estate lending has been a primary focus for us, including construction, residential mortgage and commercial mortgage loans. As a result, we are dependent on the strength of Hawaii's real estate market. According to the Honolulu Board of Realtors, Oahu unit sales volume increased just slightly by 0.3% for single-family homes but decreased by 3.2% for condominiums for the six months ended June 2012 compared to the six months ended June 2011. The median sales price for single-family homes on Oahu for the six months ended June 2012 was \$619,750, representing an increase of 8.7% from the same prior year period. The median sales price for condominiums on Oahu for the six months ended June 2012 increased slightly by 0.5% to \$306,000, compared to the same prior year period. As part of our plans to reduce our credit risk exposure, we have taken and will continue to take, steps to reduce certain aspects of our commercial real estate and construction loan portfolios. While some economists and real estate professionals remain optimistic that the Hawaii real estate market will continue to show improvement through the summer, there can be no assurance that this will occur.

While our operations are predominantly concentrated in the state of Hawaii, our performance is also influenced by economic conditions in California. California, like the rest of the nation, appears to be in the midst of an uneven economic recovery as some sectors of the economy are doing well and others are not. Most of the indicators that affect the nation, both positive and negative, also affect California. In 2011, personal income grew but these gains and many others like them paled in comparison to the losses incurred during the recession. The outlook for the California economy is guardedly positive for 2012, followed by stronger growth in 2013 and 2014. The California Association of Realtors (CAR) reported that June 2012 unit single family home sales were up 8.5% from the same period a year ago, while the median sales price increased by 8.1% from year ago levels to \$320,540. CAR anticipates California 2012 single family home resales to improve slightly by 1% to 502,800 units from 497,900 units in 2011. The California median home price is projected to increase 1.7% to \$290,900 in 2012.

According to the California Department of Finance, average personal income for 2012 call for an increase of 3.7% from 2011. Labor markets within the state improved since the year ago period but remained weak in the first half of 2012. The State of California Employment Development Department reported California's seasonally adjusted unemployment rate in June 2012 decreased to 10.7% from 11.9% in the prior year, but continues to be well above the national unemployment rate of 8.2%.

As we have seen over the past few years, our operating results are significantly impacted by the economy in Hawaii, and to a lesser extent, in California due to the composition of our loan portfolio. Loan demand, deposit growth, provision for loan and lease losses, asset quality, noninterest income and noninterest expense are all affected by changes in economic conditions. If the residential and commercial real estate markets we have exposure to do not improve or continue to deteriorate, our results of operations would be negatively impacted.

Table of Contents**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. Interest income, which includes loan fees and resultant yield information, is expressed on a taxable equivalent basis using an assumed income tax rate of 35%. A comparison of net interest income on a taxable equivalent basis ( net interest income ) for the three and six months ended June 30, 2012 and 2011 is set forth below.

|   | Average<br>Balance | 2012<br>Average<br>Yield/<br>Rate | Three Months Ended June 30, |                    | 2011<br>Average<br>Yield/<br>Rate | Amount<br>of Interest |
|---|--------------------|-----------------------------------|-----------------------------|--------------------|-----------------------------------|-----------------------|
|   |                    |                                   | Amount<br>of Interest       | Average<br>Balance |                                   | Amount<br>of Interest |
|   |                    |                                   | (Dollars in thousands)      |                    |                                   |                       |
| <b>Assets</b>                                       |                    |                                   |                             |                    |                                   |                       |
| Interest earning assets:                            |                    |                                   |                             |                    |                                   |                       |
| Interest-bearing deposits in other banks            | \$ 77,385          | 0.25%                             | \$ 47                       | \$ 471,173         | 0.26%                             | \$ 300                |
| Taxable investment securities (1)                   | 1,555,361          | 1.95                              | 7,593                       | 1,205,762          | 2.40                              | 7,241                 |
| Tax-exempt investment securities (1)                | 55,688             | 4.93                              | 686                         | 12,480             | 8.92                              | 276                   |
| Loans and leases, including loans held for sale (2) | 2,121,045          | 4.62                              | 24,393                      | 2,094,555          | 5.06                              | 26,464                |
| Federal Home Loan Bank stock                        | 48,797             |                                   |                             | 48,797             |                                   |                       |
| Total interest earning assets                       | 3,858,276          | 3.40                              | 32,719                      | 3,832,767          | 3.58                              | 34,281                |
| Nonearning assets                                   | 304,757            |                                   |                             | 214,354            |                                   |                       |
| Total assets  | \$ 4,163,033       |                                   |                             | \$ 4,047,121       |                                   |                       |
| <b>Liabilities and Equity</b>                       |                    |                                   |                             |                    |                                   |                       |
| Interest-bearing liabilities:                       |                    |                                   |                             |                    |                                   |                       |
| Interest-bearing demand deposits                    | \$ 614,480         | 0.06%                             | \$ 89                       | \$ 535,057         | 0.12%                             | \$ 161                |
| Savings and money market deposits                   | 1,158,955          | 0.09                              | 252                         | 1,113,800          | 0.18                              | 500                   |
| Time deposits under \$100,000                       | 331,866            | 0.62                              | 509                         | 402,721            | 1.03                              | 1,037                 |
| Time deposits \$100,000 and over                    | 642,349            | 0.28                              | 453                         | 438,971            | 0.79                              | 865                   |
| Short-term borrowings                               |                    |                                   |                             | 1,730              |                                   |                       |
| Long-term debt                                      | 108,291            | 3.41                              | 917                         | 409,152            | 2.59                              | 2,642                 |
| Total interest-bearing liabilities                  | 2,855,941          | 0.31                              | 2,220                       | 2,901,431          | 0.72                              | 5,205                 |
| Noninterest-bearing deposits                        | 752,512            |                                   |                             | 663,119            |                                   |                       |
| Other liabilities                                   | 70,567             |                                   |                             | 66,195             |                                   |                       |
| Total liabilities                                   | 3,679,020          |                                   |                             | 3,630,745          |                                   |                       |
| Shareholders' equity                                | 474,041            |                                   |                             | 406,381            |                                   |                       |
| Non-controlling interests                           | 9,972              |                                   |                             | 9,995              |                                   |                       |
| Total equity  | 484,013            |                                   |                             | 416,376            |                                   |                       |
| Total liabilities and equity                        | \$ 4,163,033       |                                   |                             | \$ 4,047,121       |                                   |                       |
| Net interest income                                 |                    |                                   | \$ 30,499                   |                    |                                   | \$ 29,076             |
| Net interest margin                                 |                    | 3.17%                             |                             |                    | 3.04%                             |                       |



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|   | Average<br>Balance | 2012<br>Average<br>Yield/<br>Rate | Six Months Ended June 30,                       |                    | 2011<br>Average<br>Yield/<br>Rate | Amount<br>of Interest |
|---|--------------------|-----------------------------------|---|--------------------|-----------------------------------|-----------------------|
|   |                    |                                   | Amount<br>of Interest<br>(Dollars in thousands) | Average<br>Balance |                                   |                       |
| <b>Assets</b>                                       |                    |                                   |   |                    |                                   |                       |
| Interest earning assets:                            |                    |                                   |   |                    |                                   |                       |
| Interest-bearing deposits in other banks            |                    |                                   |   |                    |                                   |                       |
|   | \$ 103,860         | 0.25%                             | \$ 128  | \$ 544,153         | 0.26%                             | \$ 689                |
| Taxable investment securities (1)                   | 1,533,916          | 1.98                              | 15,210  | 1,049,131          | 2.38                              | 12,465                |
| Tax-exempt investment securities (1)                | 34,714             | 5.70                              | 989   | 12,728             | 8.79                              | 559                   |
| Loans and leases, including loans held for sale (2) | 2,108,477          | 4.70                              | 49,401  | 2,141,816          | 5.17                              | 55,030                |
| Federal Home Loan Bank stock                        | 48,797             |                                   |   | 48,797             |                                   |                       |
| Total interest earning assets                       | 3,829,764          | 3.44                              | 65,728  | 3,796,625          | 3.64                              | 68,743                |
| Nonearning assets                                   |                    |                                   |   | 212,298            |                                   |                       |
| Total assets  | \$ 3,829,764       |                                   |   | \$ 4,008,923       |                                   |                       |
| <b>Liabilities and Equity</b>                       |                    |                                   |   |                    |                                   |                       |
| Interest-bearing liabilities:                       |                    |                                   |   |                    |                                   |                       |
| Interest-bearing demand deposits                    |                    |                                   |   |                    |                                   |                       |
|   | \$ 592,242         | 0.06%                             | \$ 175  | \$ 532,246         | 0.11%                             | \$ 293                |
| Savings and money market deposits                   |                    |                                   |   |                    |                                   |                       |
|   | 1,152,396          | 0.10                              | 551   | 1,110,691          | 0.22                              | 1,232                 |
| Time deposits under \$100,000                       | 338,137            | 0.65                              | 1,086   | 421,984            | 1.15                              | 2,403                 |
| Time deposits \$100,000 and over                    | 646,929            | 0.30                              | 949   | 386,860            | 0.98                              | 1,876                 |
| Short-term borrowings                               | 6                  | 0.76                              |   | 70,338             | 0.59                              | 204                   |
| Long-term debt                                      | 111,315            | 3.36                              | 1,860   | 424,537            | 2.55                              | 5,359                 |
| Total interest-bearing liabilities                  | 2,841,025          | 0.33                              | 4,621   | 2,946,656          | 0.78                              | 11,367                |
| Noninterest-bearing deposits                        | 740,093            |                                   |   | 670,949            |                                   |                       |
| Other liabilities                                   | 73,335             |                                   |   | 78,242             |                                   |                       |
| Total liabilities                                   | 3,654,453          |                                   |   | 3,695,847          |                                   |                       |
| Shareholders equity                                 | 468,297            |                                   |   | 303,078            |                                   |                       |
| Non-controlling interests                           | 9,975              |                                   |   | 9,998              |                                   |                       |
| Total equity  | 478,272            |                                   |   | 313,076            |                                   |                       |
| Total liabilities and equity                        | \$ 4,132,725       |                                   |   | \$ 4,008,923       |                                   |                       |
| Net interest income                                 |                    |                                   | \$ 61,107                                       |                    |                                   | \$ 57,376             |
| Net interest margin                                 |                    | 3.20%                             |   |                    | 3.04%                             |                       |

(1) At amortized cost.

(2) Includes nonaccrual loans.

Net interest income expressed on a taxable-equivalent basis of \$30.5 million for the second quarter of 2012, increased by \$1.4 million, or 4.9%, from the second quarter of 2011, while taxable-equivalent net interest income for the first half of 2012 increased by \$3.7 million, or 6.5%, to \$61.1 million from the comparable prior year period. The increase for the current quarter and first half of 2012 was primarily attributable to a significant increase in average taxable and tax-exempt investment securities and a significant decrease in long-term debt as we redeployed our excess liquidity into higher yielding investment securities and reduced our overall funding costs. In the third quarter of 2011, we paid down long-term borrowings at the FHLB totaling \$120.5 million with a weighted average interest rate of 4.36%. The increase in net interest income for the current quarter also reflects a 41 basis point ( bp ) decline in average rates paid on our interest-bearing liabilities, which exceeded the 18

bp decline in average yields earned on our interest-earning assets. The increase in net interest income for the first half of 2012 reflects a 45 bp decline in average rates paid on our interest-bearing liabilities, which exceeded the 20 bp decline in average yields earned on our interest-earning assets. The decrease in average yields earned on our interest earning assets was directly attributable to the depressed interest rate environment, reductions in our higher yielding commercial real estate loan portfolios and the corresponding increase in our lower yielding investment securities portfolio.

*Interest Income*

Taxable-equivalent interest income of \$32.7 million for the second quarter of 2012 decreased by \$1.6 million, or 4.6%, from the second quarter of 2011. The decrease was primarily attributable to a significant decline in average yields earned on loans and leases and taxable and tax-exempt investment securities, partially offset by an increase in average taxable and tax-exempt investment securities balances as described above. Average yields earned on loans and leases, taxable and tax-exempt investment securities decreased by 44 bp, 45 bp and 399 bp, respectively, in the current quarter, accounting for approximately \$2.3 million, \$1.4 million and \$0.1 million, respectively, of the current quarter's interest income decline. Average taxable and tax-exempt investment securities balances increased by \$349.6 million and \$43.2 million, respectively, in the current quarter compared to the second quarter of 2011, offsetting these declines of interest income by approximately \$2.1 million and \$1.0 million, respectively.

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Consistent with the above, the year-to-date decrease in taxable-equivalent interest income was primarily attributable to a decline in average loans and leases and the average yields earned thereon and a decline in average yields earned on taxable and tax-exempt investment securities, partially offset by an increase in average taxable and tax-exempt investment securities balances as described above. Average loans and leases decreased by \$33.3 million in the first half of 2012, accounting for approximately \$0.9 million of the year-to-date interest income decline. Average yields earned on loans and leases, taxable and tax-exempt investment securities decreased by 47 bp, 40 bp and 309 bp, respectively, in the current quarter, accounting for approximately \$5.0 million, \$2.1 million and \$0.2 million, respectively, of the year-to-date interest income decline. Average taxable and tax-exempt investment securities balances increased by \$484.8 million and \$22.0 million, respectively, in the first half of 2012 compared to the first half of 2011, offsetting these declines of interest income by approximately \$5.8 million and \$1.0 million, respectively.

*Interest Expense*

Interest expense of \$2.2 million for the second quarter of 2012 decreased by \$3.0 million, or 57.3%, from the comparable prior year quarter. The decrease was attributable to the overall decline in both average balances and rates paid on interest-bearing liabilities. The current quarter decrease of \$300.9 million in average balances of long-term debt resulted in lower interest expense of \$1.9 million. Additionally, the 41 bp decline in average rates on time deposits under \$100,000 contributed to \$0.4 million of the current quarter decrease in interest expense and the 51 bp decline in average rates on time deposits \$100,000 and over contributed to \$0.6 million of the current quarter decrease. Average time deposits \$100,000 and over increased by \$203.4 million in the current quarter compared to the second quarter of 2011, offsetting these declines of interest expense by approximately \$0.4 million.

For the first half of 2012, interest expense decreased by \$6.7 million, or 59.3%, from the first half of 2011. The decrease was attributable to the overall decline in both average balances and rates paid on interest-bearing liabilities. The year-to-date decrease of \$313.2 million in average balances of long-term debt resulted in lower interest expense of \$4.0 million. Additionally, the 12 bp decline in average rates on savings and money market deposits contributed to \$0.7 million of the year-to-date decrease in interest expense, the 50 bp decline in average rates on time deposits under \$100,000 contributed to \$1.1 million of the year-to-date decrease and the 68 bp decline in average rates on time deposits \$100,000 and over contributed to \$1.3 million of the year-to-date decrease. Average time deposits \$100,000 and over increased by \$260.1 million in the first half of 2012 compared to the first half of 2011, offsetting these declines of interest expense by approximately \$1.3 million.

*Net Interest Margin*

Our net interest margin was 3.17% for the second quarter of 2012, compared to 3.04% in the comparable prior year quarter. Our net interest margin for the first half of 2012 was 3.20% compared to 3.04% for the first half of 2011. As described above, the increase in the net interest margin for both the second quarter and first half of 2012 compared to the comparable prior year periods reflected our deployment of excess liquidity into higher yielding investment securities and an overall reduction in our funding costs, which included the aforementioned prepayment of long-term borrowings at the FHLB in the third quarter of 2011.

Table of ContentsNonperforming Assets, Accruing Loans Delinquent for 90 Days or More, Restructured Loans Still Accruing Interest

The following table sets forth nonperforming assets, accruing loans delinquent for 90 days or more and restructured loans still accruing interest as of the dates indicated.

|   | June 30,<br>2012       | December 31,<br>2011 |
|---|------------------------|----------------------|
|   | (Dollars in thousands) |                      |
| <u>Nonperforming Assets</u>   |                        |                      |
| Nonaccrual loans (including loans held for sale):   |                        |                      |
| Commercial, financial and agricultural  | \$ 3,698               | \$ 1,367             |
| Real estate:  |                        |                      |
| Construction  | 57,983                 | 69,765               |
| Mortgage-residential  | 42,199                 | 47,128               |
| Mortgage-commercial   | 16,805                 | 15,653               |
| Leases  | 264                    |                      |
| Total nonaccrual loans  | 120,949                | 133,913              |
| Other real estate   | 49,379                 | 61,681               |
| Total nonperforming assets  | 170,328                | 195,594              |
| <u>Accruing loans delinquent for 90 days or more:</u>   |                        |                      |
| Real estate:  |                        |                      |
| Construction  | 319                    |                      |
| Mortgage-residential  | 156                    |                      |
| Consumer  | 3                      | 28                   |
| Leases  | 27                     |                      |
| Total accruing loans delinquent for 90 days or more   | 505                    | 28                   |
| <u>Restructured loans still accruing interest:</u>  |                        |                      |
| Commercial, financial and agricultural  | 173                    |                      |
| Real estate:  |                        |                      |
| Construction  |                        | 5,170                |
| Mortgage-residential  | 5,436                  | 3,093                |
| Mortgage-commercial   | 3,584                  |                      |
| Total restructured loans still accruing interest  | 9,193                  | 8,263                |
| Total nonperforming assets, accruing loans delinquent for 90 days or more and restructured loans still accruing interest  | \$ 180,026             | \$ 203,885           |
| Total nonperforming assets as a percentage of loans and leases, loans held for sale and other real estate   | 7.81%                  | 8.99%                |
| Total nonperforming assets and accruing loans delinquent for 90 days or more as a percentage of loans and leases, loans held for sale and other real estate   | 7.83%                  | 8.99%                |
| Total nonperforming assets, accruing loans delinquent for 90 days or more and restructured loans still accruing interest as a percentage of loans and leases, loans held for sale and other real estate | 8.25%                  | 9.37%                |

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Nonperforming assets, which includes nonaccrual loans and leases, nonperforming loans classified as held for sale and foreclosed real estate, totaled \$170.3 million at June 30, 2012, compared to \$195.6 million at December 31, 2011. The decrease from December 31, 2011 was attributable to \$39.3 million in repayments, \$12.8 million in sales of foreclosed properties \$6.6 million in loans restored to accrual status, \$5.3 million in charge-offs, and \$3.4 million in write-downs of foreclosed properties, partially offset by \$42.1 million in gross additions. California construction and development loans to a single borrower totaling \$25.7 million accounted for the majority of the gross additions during the first half of 2012.

Net changes to nonperforming assets by category included net decreases in Hawaii construction and development assets totaling \$23.9 million, Hawaii residential mortgage assets totaling \$7.4 million and Hawaii commercial mortgage assets totaling \$3.4 million. Partially offsetting these net decreases were net increases in Mainland commercial mortgage assets totaling \$4.5 million, Hawaii commercial assets totaling \$2.3 million and Mainland construction and development assets totaling \$2.2 million.



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Restructured loans included in nonperforming assets at June 30, 2012 consisted of 82 Hawaii residential mortgage loans with a combined principal balance of \$35.3 million, a Mainland construction and development loan with a principal balance of \$13.2 million, two Mainland commercial mortgage loans with a combined principal balance of \$6.4 million, seven Hawaii construction and development loans with a combined principal balance of \$2.8 million, a Hawaii commercial mortgage loan with a principal balance of \$0.5 million and a Hawaii commercial loan with a principal balance of \$0.2 million. Concessions made to the original contractual terms of these loans consisted primarily of the deferral of interest and/or principal payments due to deterioration in the borrowers' financial condition. The principal balances on these restructured loans matured and/or were in default at the time of restructuring and we have no commitments to lend additional funds to any of these borrowers. There were \$9.2 million of restructured loans still accruing interest at June 30, 2012, none of which were more than 90 days delinquent.

Provision and Allowance for Loan and Lease Losses

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

|  | Three Months Ended<br>June 30, |            | Six Months Ended<br>June 30, |            |
|--|--------------------------------|------------|------------------------------|------------|
|  | 2012                           | 2011       | 2012                         | 2011       |
|  | (Dollars in thousands)         |            |                              |            |
| Allowance for loan and lease losses:         |                                |            |                              |            |
| Balance at beginning of period               | \$ 114,322                     | \$ 178,010 | \$ 122,093                   | \$ 192,854 |
| Provision (credit) for loan and lease losses | (6,630)                        | (8,784)    | (11,620)                     | (10,359)   |
| Charge-offs:                                 |                                |            |                              |            |
| Commercial, financial and agricultural       | 1,394                          | 455        | 3,076                        | 1,861      |
| Real estate:                                 |                                |            |                              |            |
| Construction                                 | 3,715                          | 3,000      | 5,341                        | 16,858     |
| Mortgage-residential                         | 173                            | 1,263      | 373                          | 3,299      |
| Mortgage-commercial                          | 320                            | 879        | 320                          | 1,105      |
| Consumer                                     | 323                            | 597        | 749                          | 1,202      |
| Leases                                       |                                |            | 28                           |            |
| Total charge-offs                            | 5,925                          | 6,194      | 9,887                        | 24,325     |
| Recoveries:                                  |                                |            |                              |            |
| Commercial, financial and agricultural       | 832                            | 854        | 1,102                        | 1,286      |
| Real estate:                                 |                                |            |                              |            |
| Construction                                 | 745                            | 2,549      | 1,170                        | 5,915      |
| Mortgage-residential                         | 262                            | 231        | 379                          | 931        |
| Mortgage-commercial                          | 2                              | 3          | 4                            | 42         |
| Consumer                                     | 204                            | 265        | 570                          | 590        |
| Leases                                       | 2                              |            | 3                            |            |
| Total recoveries                             | 2,047                          | 3,902      | 3,228                        | 8,764      |
| Net charge-offs                              | 3,878                          | 2,292      | 6,659                        | 15,561     |
| Balance at end of period                     | \$ 103,814                     | \$ 166,934 | \$ 103,814                   | \$ 166,934 |
|  | 0.73%                          | 0.44%      | 0.63%                        | 1.45%      |

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Annualized ratio of net charge-offs to average  
loans

Our Allowance at June 30, 2012 totaled \$103.8 million, a decrease of \$18.3 million, or 15.0%, from year-end 2011. The decrease in our Allowance was a direct result of a credit to the Provision of \$11.6 million and \$6.7 million in net loan charge-offs.

Our Provision was a credit of \$6.6 million during the second quarter of 2012, compared to a credit of \$8.8 million in the second quarter of 2011. The credit to the Provision recorded during the quarter was the result of continued improvement in the historical quarterly charge-off data used to calculate the Allowance and an overall improvement in the Company's credit risk profile, as evidenced by the previously mentioned decrease in nonperforming assets.

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Our Allowance as a percentage of our total loan portfolio decreased from 5.91% at December 31, 2011 to 4.94% at June 30, 2012. Our Allowance as a percentage of our nonperforming assets decreased from 62.42% at December 31, 2011 to 60.95% at June 30, 2012.

The decrease in the Allowance is consistent with our reduction in nonperforming assets and our belief that we continue to see signs of stabilization in certain sectors of our loan portfolio, the overall economy and the commercial real estate markets both in Hawaii and on the Mainland.

Depending on the overall performance of the local and national economies, the strength of the Hawaii and California commercial real estate markets and the accuracy of our assumptions and judgments concerning our loan portfolio, further adverse credit migration is possible due to the upcoming maturity of additional loans, the possibility of further declines in collateral values and the potential impact of continued financial stress on our borrowers, sponsors and guarantors as they attempt to endure the challenges of the current economic environment. While we have seen preliminary signs of stabilization, we cannot determine when, or if, the challenging economic conditions that we experienced over the past four years will improve and whether or not recent signs of an economic recovery will continue.

In accordance with GAAP, loans held for sale and other real estate assets are not included in our assessment of the Allowance.

Other Operating Income

Total other operating income of \$13.6 million for the second quarter of 2012 increased by \$2.7 million, or 24.5%, from the comparable prior year period. The increase was primarily due to higher gains on sales of residential mortgage loans of \$2.4 million, higher unrealized gains on outstanding interest rate locks of \$0.7 million and higher rental income from foreclosed properties of \$0.6 million, partially offset by the recognition of a \$0.3 million gain on sale of investment securities in the second quarter of 2011.

For the six months ended June 30, 2012, total other operating income of \$26.8 million increased by \$3.4 million, or 14.6%, from the comparable prior year period. The increase was primarily due to higher gains on sales of residential mortgage loans of \$3.2 million, higher rental income from foreclosed properties of \$1.7 million and higher unrealized gains on outstanding interest rate locks of \$0.6 million, partially offset by lower income from bank-owned life insurance of \$0.6 million, lower service charges on deposits accounts of \$0.5 million and the recognition of a \$0.3 million gain on sale of investment securities in the second quarter of 2011.

Other Operating Expense

Total other operating expense for the second quarter of 2012 was \$39.7 million, compared to \$40.5 million in the comparable prior year period. The decrease was primarily attributable to a lower provision for repurchased residential mortgage loans of \$3.1 million, lower net credit-related charges (which include write-downs of loans held for sale, foreclosed asset expense, and changes in the reserve for unfunded commitments) of \$0.9 million and lower FDIC insurance expense of \$0.6 million, partially offset by higher salaries and employee benefits of \$2.2 million, accruals totaling \$2.0 million related to two legal proceedings against the Company, and the previously mentioned impairment charges relating to our customer relationships and non-compete intangible assets totaling \$0.9 million.

For the six months ended June 30, 2012, total other operating expense of \$74.9 million decreased by \$3.2 million, or 4.1%, from the comparable prior year period. The decrease was primarily attributable to lower net credit-related charges of \$4.2 million, a lower provision for repurchased residential mortgage loans of \$3.0 million and lower FDIC insurance of \$2.3 million, partially offset by higher salaries and employee benefits of \$3.8 million, the aforementioned accrual of \$2.0 million in settlements of legal proceedings, higher legal and professional services of \$1.1 million and the aforementioned impairment charges of \$0.9 million.

#### Income Taxes

We did not recognize any income tax expense in the first half of 2012 or 2011, as we continue to recognize a full valuation allowance against our net DTAs, which was first established in the third quarter of 2009. The establishment of the valuation allowance was primarily based upon our recent net operating losses and the existence of a three-year cumulative loss, which led to our conclusion that it was more likely than not that our DTAs would not be fully realized. In determining the extent of the valuation allowance, management also considered, among other things, carryback/carryforward periods available to us and trends in our historical and projected earnings.

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During the first half of 2012, we decreased our valuation allowance against our net DTAs by \$7.2 million to \$155.1 million at June 30, 2012 from \$162.3 million at December 31, 2011. Of the total decrease to the valuation allowance, \$7.8 million was recognized as a non-cash credit to income tax expense, while \$0.6 million was debited to accumulated other comprehensive income ( AOCI ).

**Financial Condition**

Total assets at June 30, 2012 of \$4.2 billion increased by \$94.2 million from \$4.1 billion at December 31, 2011.

Loans and Leases

Loans and leases, net of unearned income, of \$2.1 billion at June 30, 2012, increased by \$36.7 million, or 1.8%, from December 31, 2011. The increase was primarily due to net increases in the residential mortgage and commercial, financial and agricultural loan portfolios totaling \$81.4 million and \$17.0 million, respectively, partially offset by a net reduction in the construction and development loan portfolio totaling \$54.6 million. The net increases in these portfolios reflect transfers of 11 portfolio loans to other real estate totaling \$2.0 million, the transfer of a portfolio loan to the held-for-sale category of \$0.3 million and charge-offs of loans and leases of \$9.9 million.

The following table sets forth the geographic distribution of our loan and leases portfolio and related Allowance as of June 30, 2012:

|  | Hawaii       | Mainland<br>(Dollars in thousands) | Total        |
|--|--------------|------------------------------------|--------------|
| Commercial, financial and agricultural | \$ 195,760   | \$ 1,931                           | \$ 197,691   |
| Real estate:                           |              |                                    |              |
| Construction                           | 66,438       | 40,027                             | 106,465      |
| Mortgage - residential                 | 976,163      | 1,301                              | 977,464      |
| Mortgage - commercial                  | 493,620      | 203,713                            | 697,333      |
| Consumer                               | 108,276      |                                    | 108,276      |
| Leases                                 | 13,934       |                                    | 13,934       |
| Total loans and leases                 | 1,854,191    | 246,972                            | 2,101,163    |
| Allowance for loan and lease losses    | (69,520)     | (34,294)                           | (103,814)    |
| Net loans and leases                   | \$ 1,784,671 | \$ 212,678                         | \$ 1,997,349 |

Deposits

Total deposits of \$3.6 billion at June 30, 2012 reflected an increase of \$118.8 million, or 3.4%, from December 31, 2011. The increase was primarily attributable to increases in interest-bearing demand deposits, non-interest bearing demand deposits and savings and money market deposits of \$57.2 million, \$39.9 million and \$24.9 million, respectively. These increases were partially offset by a decrease in time deposits of \$3.2 million.

Core deposits, which we define as demand deposits, savings and money market deposits, and time deposits less than \$100,000, totaled \$2.8 billion at June 30, 2012 and increased by \$95.6 million from December 31, 2011.

### **Capital Resources**

#### Common Stock

Shareholders' equity totaled \$480.5 million at June 30, 2012, compared to \$456.4 million at December 31, 2011. The increase in total shareholders' equity was attributable to the \$24.3 million in net income recognized during the first half of 2012.

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On June 22, 2011, the United States Department of the Treasury (the "Treasury") completed a public underwritten offering of 2,850,000 shares of our common stock it received in the TARP Exchange. On April 4, 2012, the Treasury completed another public underwritten offering of its remaining 2,770,117 shares of our common stock it received in the TARP Exchange. The Company did not receive any proceeds from either of these offerings. The Treasury continues to hold a warrant to purchase 79,288 shares of our common stock.

## Trust Preferred Securities

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. Our obligations with respect to the issuance of the trust preferred securities constitute a full and unconditional guarantee by the Company of each trust's obligations with respect to its trust preferred securities. Subject to certain exceptions and limitations, we may elect from time to time to defer subordinated debenture interest payments, which would result in a deferral of dividend payments on the related trust preferred securities, for up to 20 consecutive quarterly periods without default or penalty. We began deferring interest and dividend payments on the subordinated debentures and the trust preferred securities in the third quarter of 2009. During the deferral period, which currently stands at 12 consecutive quarters, the respective trusts are likewise suspending the declaration and payment of dividends on the trust preferred securities. Also during the deferral period, we may not, among other things and with limited exceptions, pay cash dividends on or repurchase our common stock or make any payment on outstanding debt obligations that rank equally with or junior to the junior subordinated debentures. During the deferral period, we will continue to accrue, and reflect in our consolidated financial statements, the deferred interest payments on our junior subordinated debentures. At June 30, 2012, accrued interest on our outstanding junior subordinated debentures relating to our trust preferred securities was \$10.3 million.

The FRB has determined that certain cumulative preferred securities having the characteristics of trust preferred securities to qualify as non-controlling interest, and are included in CPF's Tier 1 capital. As previously noted, recent legislative provisions that revoke Tier 1 capital treatment of trust preferred securities do not apply to the five statutory trusts referred to above as they were issued before May 19, 2010 and were grandfathered under an exception for depository institution holding companies with total consolidated assets of less than \$15 billion as of December 31, 2009.

## Holding Company Capital Resources

CPF is required to act as a source of strength to the bank under the Bank Holding Company Act. The majority of the funds that we received upon completion of the Private Placement were contributed by CPF to the bank as capital. CPF is obligated to pay its expenses, including payments on its outstanding trust preferred securities. In the past, CPF has primarily relied upon dividends from the bank for its cash flow needs. However, as a Hawaii state-chartered bank, the bank is prohibited from declaring or paying dividends greater than its retained earnings. As of June 30, 2012, the bank had an accumulated deficit of \$414.1 million. The bank will need to eliminate the deficit and generate positive retained earnings before it can pay any dividends. As a result, we do not anticipate receiving dividends from the bank in the foreseeable future. On a stand alone basis, as of June 30, 2012, CPF had approximately \$44.2 million of cash available to meet its ongoing obligations.

## Capital Ratios

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General capital adequacy regulations adopted by the FRB and FDIC require an institution 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 to be 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.

FDIC-insured institutions must maintain leverage, Tier 1 and total risk-based capital ratios of at least 5%, 6% and 10%, respectively, and not be subject to a regulatory capital directive to be considered well capitalized under the prompt corrective action provisions of the FDIC Improvement Act of 1991. The Company's and the bank's leverage capital, Tier 1 and total risk-based capital ratios as of June 30, 2012 were above the levels required for a well capitalized regulatory designation and the bank is currently in compliance with the Bank MOU which requires that it maintain a leverage capital ratio of at least 8%.



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The following table sets forth the Company's and the bank's capital ratios, as well as the minimum capital adequacy requirements applicable to all financial institutions as of the dates indicated.

| (Dollars in thousands)      | Actual     |       | Minimum Required<br>for Capital<br>Adequacy Purposes |       | Minimum Required<br>to be<br>Well Capitalized |       |
|-----------------------------|------------|-------|--|-------|---|-------|
|                             | Amount     | Ratio | Amount   | Ratio | Amount  | Ratio |
| <b>Company</b>              |            |       |  |       |   |       |
| At June 30, 2012:           |            |       |  |       |   |       |
| Leverage capital            | \$ 582,879 | 14.1% | \$ 165,093   | 4.0%  | \$ 206,366                                    | 5.0%  |
| Tier 1 risk-based capital   | 582,879    | 23.0  | 101,209  | 4.0   | 151,814                                       | 6.0   |
| Total risk-based capital    | 615,456    | 24.3  | 202,419  | 8.0   | 253,023                                       | 10.0  |
| At December 31, 2011:       |            |       |  |       |   |       |
| Leverage capital            | \$ 555,315 | 13.8% | \$ 161,218   | 4.0%  | \$ 201,522                                    | 5.0%  |
| Tier 1 risk-based capital   | 555,315    | 22.9  | 96,845   | 4.0   | 145,267                                       | 6.0   |
| Total risk-based capital    | 586,802    | 24.2  | 193,690  | 8.0   | 242,112                                       | 10.0  |
| <b>Central Pacific Bank</b> |            |       |  |       |   |       |
| At June 30, 2012:           |            |       |  |       |   |       |
| Leverage capital            | \$ 554,393 | 13.4% | \$ 165,165   | 4.0%  | \$ 206,456                                    | 5.0%  |
| Tier 1 risk-based capital   | 554,393    | 21.9  | 101,296  | 4.0   | 151,944                                       | 6.0   |
| Total risk-based capital    | 586,988    | 23.2  | 202,592  | 8.0   | 253,240                                       | 10.0  |
| At December 31, 2011:       |            |       |  |       |   |       |
| Leverage capital            | \$ 524,057 | 13.0% | \$ 161,259   | 4.0%  | \$ 201,574                                    | 5.0%  |
| Tier 1 risk-based capital   | 524,057    | 21.6  | 96,916   | 4.0   | 145,375                                       | 6.0   |
| Total risk-based capital    | 555,566    | 22.9  | 193,833  | 8.0   | 242,291                                       | 10.0  |

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**Liquidity and Borrowing Arrangements**

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 changes in loan and deposit balances on a daily basis to ensure maximum utilization, maintenance of an adequate level of readily marketable assets and access to short-term funding sources.

Core deposits have historically provided us with a sizeable source of relatively stable and low cost funds, but are subject to competitive pressure in our market. In addition to core deposit funding, we also have access to a variety of other short-term and long-term funding sources, which include proceeds from maturities of our investment securities, as well as secondary funding sources such as the FHLB, secured repurchase agreements, federal funds borrowings and the Federal Reserve discount window, available to meet our liquidity needs. While we historically have had access to these alternative funding sources, access to these sources is not guaranteed and may be influenced by market conditions, our financial position, and the terms of the respective agreements with such sources, as discussed below.

The bank is a member of and maintained an \$808.4 million line of credit with the FHLB as of June 30, 2012. At June 30, 2012, we did not have any short-term borrowings outstanding under this arrangement and our long-term borrowings totaled \$40,000. At December 31, 2011, we did not have any short-term borrowings outstanding under this arrangement and our long-term borrowings totaled \$50.0 million.

In February 2009, the bank's collateral arrangement with the FHLB converted from a blanket pledge arrangement to a physical possession arrangement whereby the bank was required to deliver certain original loan documents to the FHLB for the collateral securing advances. In December 2010, the FHLB expanded the physical possession collateral arrangement to require copies of all loan documents for the collateral securing advances. In September 2011, the FHLB removed the physical possession requirement and replaced it with a listing arrangement whereby the bank now provides the FHLB with a monthly list of pledged assets that is used to secure all advances.

As of June 30, 2012, the bank's pledged assets to the FHLB included investment securities with a fair value of \$169.2 million and certain real estate loans totaling \$986.8 million. These assets can be used to secure future advances in accordance with the collateral provisions of the Advances, Security and Deposit Agreement with the FHLB.

Besides its line of credit with the FHLB, the bank also maintained a \$29.6 million line of credit with the Federal Reserve discount window. There were no borrowings under this arrangement at June 30, 2012 and December 31, 2011. Advances under this arrangement would have been secured by certain commercial and commercial real estate loans with a carrying value of \$49.3 million at June 30, 2012. The Federal Reserve does not have the right to sell or repledge these loans. In September 2011, the bank was upgraded from the Federal Reserve's secondary credit facility to the primary credit facility, and regained its eligibility for the Borrower-in-Custody program.

Our ability to maintain adequate levels of liquidity is dependent on us continuing to execute our recovery plan, and more specifically, our ability to continue to improve our credit risk profile, maintain our capital base, and comply with the provisions of our agreements with regulators. Beyond the challenges specific to our situation, our liquidity may also be negatively impacted by weakness in the financial markets and industry-wide reductions in liquidity.

**Contractual Obligations**

Information regarding our contractual obligations is provided in Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations of our Annual Report on Form 10-K for the year ended December 31, 2011. There have been no material changes in our contractual obligations since December 31, 2011.

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**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 June 30, 2012 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.

**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 are reasonably likely to materially affect, our internal control over financial reporting.

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**PART II. OTHER INFORMATION**

**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, 2011, filed with the SEC.

**Item 6. Exhibits**

| <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 **  |
| 101.INS            | XBRL Instance Document*  |
| 101.SCH            | XBRL Taxonomy Extension Schema Document*   |
| 101.CAL            | XBRL Taxonomy Extension Calculation Linkbase Document*   |
| 101.LAB            | XBRL Taxonomy Extension Label Linkbase Document*   |
| 101.PRE            | XBRL Taxonomy Extension Presentation Linkbase Document*  |
| 101.DEF            | XBRL Taxonomy Extension Definition Linkbase Document*  |

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\* Filed herewith.

\*\* Furnished herewith.

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**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: August 9, 2012

/s/ John C. Dean  
John C. Dean  
President and Chief Executive Officer

Date: August 9, 2012

/s/ Denis K. Isono  
Denis K. Isono  
Executive Vice President and Chief Financial Officer

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**Central Pacific Financial Corp.**

**Exhibit Index**

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