PROVIDENT FINANCIAL HOLDINGS INC
Form 10-K
September 12, 2007

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

(Mark one) **FORM 10-K**

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

For the fiscal year ended June 30, 2007 **OR**

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

Commission File Number: 000-28304

PROVIDENT FINANCIAL HOLDINGS, INC.
(Exact name of registrant as specified in its charter)

Delaware	33-0704889
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)
3756 Central Avenue, Riverside, California	92506
(Address of principal executive offices)	(Zip Code)

Registrant's telephone number, including area code: (951) 686-6060

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

Common Stock, par value $.01 per share	The Nasdaq Stock Market LLC
(Title of Each Class)	(Name of Each Exchange on Which Registered)

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

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

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

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 _X_ NO __.

Indicate by check mark whether disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the Registrant's knowledge, in definitive proxy or other information statements incorporated by reference in Part III of this Form 10-K or any amendments to this Form 10-K.
[ ]

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 _X_ Non-accelerated filer _____

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

As of September 5, 2007, there were 6,297,318 shares of the Registrant's common stock issued and outstanding. The Registrant's common stock is listed on the Nasdaq Global Market of The Nasdaq Stock Market LLC under the symbol "PROV." The aggregate market value of the common stock held by nonaffiliates of the Registrant, based on the closing sales price of the Registrant's common stock as quoted on The Nasdaq Stock Market LLC on December 29, 2006, was $203.7 million.

DOCUMENTS INCORPORATED BY REFERENCE

1. Portions of the Annual Report to Shareholders are incorporated by reference into Part II.

2. Portions of the definitive Proxy Statement for the fiscal 2007 Annual Meeting of Shareholders ("Proxy Statement") are incorporated by reference into Part III.

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PROVIDENT FINANCIAL HOLDINGS, INC.

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PART I

Item 1. Business

General

Provident Financial Holdings, Inc. (the "Corporation"), a Delaware corporation, was organized in January 1996 for the purpose of becoming the holding company for Provident Savings Bank, F.S.B. (the "Bank") upon the Bank's conversion from a federal mutual to a federal stock savings bank ("Conversion"). The Conversion was completed on June 27, 1996. At June 30, 2007, the Corporation had total assets of $1.6 billion, total deposits of $998.6 million and stockholders' equity of $128.9 million. The Corporation has not engaged in any significant activity other than holding the stock of the Bank. Accordingly, the information set forth in this Annual Report on Form 10-K ("Form 10-K"), including financial statements and related data, relates primarily to the Bank and its subsidiaries.

The Bank, founded in 1956, is a federally chartered stock savings bank headquartered in Riverside, California. The Bank is regulated by the Office of Thrift Supervision ("OTS"), its primary federal regulator, and the Federal Deposit Insurance Corporation ("FDIC"), the insurer of its deposits. The Bank's deposits are federally insured up to applicable limits by the FDIC. The Bank has been a member of the Federal Home Loan Bank ("FHLB") - San Francisco since 1956.

The Bank is a financial services company committed to serving consumers and small to mid-sized businesses in the Inland Empire region of Southern California. The Bank conducts its business operations as Provident Bank, Provident Bank Mortgage ("PBM"), a division of the Bank, and through its subsidiary, Provident Financial Corp. The business activities of the Bank consist of community banking, mortgage banking, investment services and trustee services. Financial information regarding the Corporation's two operating segments, Provident Bank and PBM, is contained in Note 17 to the Corporation's audited consolidated financial statements included in Item 8 of this Form 10-K.

The Bank's community banking operations primarily consist of accepting deposits from customers within the communities surrounding its full service offices and investing those funds in single-family, multi-family, commercial real estate, construction, commercial business, consumer and other loans. Mortgage banking activities consist of the origination of single-family mortgage loans (including second mortgages and equity lines of credit) for sale and for investment. Through its subsidiary, Provident Financial Corp, the Bank conducts trustee services for the Bank's real estate transactions and has in the past held, and may in the future hold, real estate for investment. The Bank now offers investment and insurance services directly, rather than through its subsidiary. See "Subsidiary Activities" on page 31 of this Form 10-K. The Bank's revenues are derived principally from interest earned on its loan and investment portfolios, and fees generated through its community banking and mortgage banking activities.

On June 22, 2006, the Bank established the Provident Savings Bank Charitable Foundation ("Foundation") in order to further its commitment to the local community. The specific purpose of the Foundation is to promote and provide for the betterment of youth, education, housing and the arts in the Bank's primary market areas of Riverside and San Bernardino Counties. The Foundation was funded with a $500,000 charitable contribution made by the Bank in the fourth quarter of fiscal 2006. No additional funds were contributed by the Bank to the Foundation during fiscal 2007.

Subsequent Events:

Cash dividend

On July 26, 2007, the Corporation announced a cash dividend of $0.18 per share on the Corporation's outstanding shares of common stock for shareholders of record at the close of business on August 20, 2007, which was paid on September 10, 2007.

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Market Area

The Bank is headquartered in Riverside, California and operates 12 full-service banking offices in Riverside County and one full-service banking office in San Bernardino County. Management considers Riverside and Western San Bernardino Counties to be the Bank's primary market for deposits. Through the operations of PBM, the Bank has expanded its retail lending market to include a large portion of Southern California and a small portion of Northern California. As of June 30, 2007, there were nine PBM loan production offices located in southern California (primarily in Los Angeles, Riverside, San Bernardino and San Diego Counties) and one PBM loan production office in northern California. PBM's loan production offices include three wholesale loan offices through which the Bank maintains a network of loan correspondents. Most of the Bank's business is conducted in the communities surrounding its full-service branches and loan production offices.

The large geographic area encompassing Riverside and San Bernardino Counties is referred to as the "Inland Empire." According to 2000 Census Bureau population statistics, Riverside and San Bernardino Counties have the sixth and fifth largest county populations in California, respectively. The Bank's market area consists primarily of suburban and urban communities. Western Riverside and San Bernardino Counties are relatively densely populated and are within the greater Los Angeles metropolitan area. The Inland Empire has enjoyed economic strength over the past several years. Many corporations are moving their offices and warehouses to the Inland Empire, which offers more affordable sites and more affordable housing for their employees. This trend has resulted in a significant improvement in real estate property values over the past several years. However, recent slowdowns in the real estate market have effected property values nationwide, including the Inland Empire. The unemployment rate in the Inland Empire in June 2007 was 5.6%, compared to 5.2% in California and 4.5% nationwide, according to U.S. Department of Labor, Bureau of Labor Statistics.

Competition

The Bank faces significant competition in its market area in originating real estate loans and attracting deposits. The rapid population growth in the Inland Empire has attracted numerous financial institutions to the Bank's market area. The Bank's primary competitors are large regional and super-regional commercial banks as well as other community-oriented banks and savings institutions. The Bank also faces competition from credit unions and a large number of mortgage companies that operate within its market area. Many of these institutions are significantly larger than the Bank and therefore have greater financial and marketing resources than the Bank. The Bank's mortgage banking operations also face strong competition from mortgage bankers, brokers and other financial institutions. This competition may limit the Bank's growth and profitability in the future.

Personnel

As of June 30, 2007, the Bank had 315 full-time equivalent employees, which consisted of 256 full-time, 59 prime-time and 31 part-time employees. The employees are not represented by a collective bargaining unit and the Bank believes that its relationship with employees is good.

Segment Reporting

Financial information regarding the Corporation's operating segments is contained in Note 17 to the audited consolidated financial statements included in Item 8 of this report.

Internet Website

The Corporation maintains a website at www.myprovident.com. The information contained on that website is not included as a part of, or incorporated by reference into, this Annual Report on Form 10-K. Other than an investor's own internet access charges, the Corporation makes available free of charge through that website the Corporation's Annual Report on Form 10-K, quarterly reports on Form 10-Q and current reports on Form 8-K, and amendments to these reports, as soon as reasonably practicable after these materials have been electronically filed with, or furnished to, the Securities and Exchange Commission.

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Lending Activities

General. The lending activity of the Bank is predominately comprised of the origination of conventional mortgage loans secured by single-family residential properties for investment (predominantly adjustable rate) and sale (predominantly fixed rate). The Bank also originates multi-family, commercial real estate, construction, commercial business, consumer and other loans to be held for investment. The Bank's net loans held for investment were $1.35 billion at June 30, 2007, representing approximately 81.9% of consolidated total assets. This compares to $1.26 billion, or 77.8% of consolidated total assets, at June 30, 2006.

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Loans Held For Investment Analysis. The following table sets forth the composition of the Bank's loans held for investment at the dates indicated.

	At June 30,									
	2007		2006		2005		2004		2003	
	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent

(Dollars In Thousands)										
Mortgage loans:										
Single-family	$ 826,249	59.68%	$ 828,091	61.16%	$ 808,732	65.56%	$ 620,087	65.48%	$ 531,255	64.89%
Multi-family	330,231	23.85	219,072	16.18	119,715	9.70	68,804	7.27	49,699	6.07
Commercial real estate	147,545	10.66	127,342	9.41	122,354	9.92	99,919	10.55	89,666	10.95
Construction	60,571	4.37	149,517	11.05	155,975	12.65	136,265	14.39	118,784	14.51
Total mortgage loans	1,364,596	98.56	1,324,022	97.80	1,206,776	97.83	925,075	97.69	789,404	96.42
Commercial business loans	10,054	0.73	12,911	0.95	15,268	1.24	13,770	1.45	22,489	2.75
Consumer loans	509	0.04	734	0.05	778	0.06	730	0.08	1,086	0.13
Other loans	9,307	0.67	16,244	1.20	10,767	0.87	7,371	0.78	5,724	0.70
Total loans held for investment	1,384,466	100.00%	1,353,911	100.00%	1,233,589	100.00%	946,946	100.00%	818,703	100.00%
Undisbursed loan funds	(25,484)		(84,024)		(95,162)		(78,137)		(67,868)	
Deferred loan costs	5,152		3,417		2,693		1,340		602	
Allowance for loan losses	(14,845)		(10,307)		(9,215)		(7,614)		(7,218)	
Total loans held for investment, net	$ 1,349,289		$ 1,262,997		$ 1,131,905		$ 862,535		$ 744,219	
Loans held for sale, at lower of cost or market	$ 1,337		$ 4,713		$ 5,691		$ 20,127		$ 4,247	

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Maturity of Loans Held for Investment. The following table sets forth information at June 30, 2007 regarding the dollar amount of principal payments becoming contractually due during the periods indicated for loans held for investment. Demand loans, loans having no stated schedule of principal payments, loans having no stated maturity, and overdrafts are reported as becoming due within one year. The table does not include any estimate of prepayments, which can significantly shorten the average life of loans held for investment and may cause the Bank's actual principal payment experience to differ materially from that shown below.

(In Thousands)	Within One Year	After One Year Through 3 Years	After 3 Years Through 5 Years	After 5 Years Through 10 Years	Beyond 10 Years	Total
Mortgage loans:						
Single-family	$ 1,720	$ 526	$ 1,988	$ 5,665	$ 816,350	$ 826,249
Multi-family	1,446	2,292	3,068	103,643	219,782	330,231
Commercial real estate	4,718	1,767	10,726	119,851	10,483	147,545
Construction	54,590	-	-	-	5,981	60,571
Commercial business loans	3,420	3,784	2,025	825	-	10,054
Consumer loans	503	6	-	-	-	509
Other loans	8,755	552	-	-	-	9,307
Total loans held for investment	$ 75,152	$ 8,927	$ 17,807	$ 229,984	$ 1,052,596	$ 1,384,466

The following table sets forth the dollar amount of all loans held for investment due after June 30, 2008 which have fixed and floating or adjustable interest rates.

(In Thousands)	Fixed-Rate	Floating or Adjustable Rate
Mortgage loans:		
Single-family	$ 11,714	$ 812,815
Multi-family	15,546	313,239
Commercial real estate	17,529	125,298
Construction	-	5,981
Commercial business loans	2,932	3,702
Consumer loans	6	-
Other loans	552	-
Total loans held for investment	$ 48,279	$ 1,261,035

Scheduled contractual principal payments of loans do not reflect the actual life of such assets. The average life of loans is substantially less than their contractual terms because of prepayments. In addition, due-on-sale clauses generally give the Bank the right to declare loans immediately due and payable in the event, among other things, the borrower sells the real property subject to the mortgage. The average life of mortgage loans tends to increase, however, when current market interest rates are substantially higher than the interest rates on existing loans held for investment and, conversely, decrease when the interest rates on existing loans held for investment are substantially higher than current market interest rates.

Single-Family Mortgage Loans. The Bank's predominant lending activity is the origination by PBM of loans secured by first mortgages on owner-occupied, single-family (one to four units) residences in the communities where the Bank has established full service branches and loan production offices. At June 30, 2007, total single-family loans held for investment decreased to $826.2 million, or 59.7% of the total loans held for investment from

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$828.1 million, or 61.2% of the total loans held for investment at June 30, 2006. The decrease in the single-family loans in fiscal 2007 was primarily attributable to loan prepayments, partly offset by $204.4 million of new loan originations.

The Bank's residential mortgage loans are generally underwritten and documented in accordance with guidelines established by major Wall Street firms, institutional loan buyers, Freddie Mac and Fannie Mae (collectively, "the secondary market"). All government insured loans are generally underwritten and documented in accordance with the guidelines established by the Department of Housing and Urban Development ("HUD") and the Veterans' Administration ("VA"). Loans are normally classified as either conforming (meeting agency criteria) or non-conforming (meeting an investor's criteria). These non-conforming loans are additionally classified as "A" or "Alt-A". The "A" loans are typically those that exceed agency loan limits but closely mirror agency underwriting criteria. The "Alt-A" loans are underwritten to expanded guidelines allowing a borrower with good credit a broader range of product choices. The "Alt-A" criteria includes interest-only loans, stated-income loans and greater than 30-year amortization loans. Given the current market environment, the production of these non-conforming loans is expected to decrease.

The Bank offers closed-end, fixed-rate home equity loans that are secured by the borrower's primary residence. These loans do not exceed 100% of the appraised value of the residence and have terms of up to 15 years requiring monthly payments of principal and interest. At June 30, 2007, home equity loans amounted to $6.6 million, or 0.8% of single-family loans as compared to $2.0 million, or 0.2% of single-family loans at June 30, 2006. The Bank also offers secured lines of credit, which are generally secured by a second mortgage on the borrower's primary residence. Secured lines of credit have an interest rate that is typically one to two percentage points above the prime lending rate. As of June 30, 2007 and 2006, the outstanding secured lines of credit were $886,000 and $1.3 million, respectively.

The Bank offers adjustable rate mortgage ("ARM") loans at rates and terms competitive with market conditions. Substantially all of the ARM loans originated by the Bank meet the underwriting standards of the secondary market. The Bank offers several ARM products, which adjust monthly, semi-annually, or annually after an initial fixed period ranging from one month to five years subject to a limitation on the annual increase of one to two percentage points and an overall limitation of three to six percentage points. The ARM loans in the Bank's loans held for investment utilize the London Interbank Offered Rate index ("LIBOR"), the FHLB Eleventh District cost of funds index ("COFI"), the 12-month average Treasury index ("12 MAT") or the weekly average yield on one year U.S. Treasury securities adjusted to a constant maturity of one year index ("CMT"), plus a margin of 2.00% to 3.25%. Loans based on the LIBOR index constitute a majority of the Bank's loans held for investment. The majority of the ARM loans held for investment have three- or five-year fixed periods prior to the first adjustment ("3/1 or 5/1 hybrids"), and do not require principal amortization for up to 120 months. Loans of this type have embedded interest rate risk if interest rates should rise during the initial fixed rate period. To coincide with the Bank's 50^{th} Anniversary, the Bank began offering 50-year single-family mortgage loans in fiscal 2006. The Bank had a total of 51 loans for $20.7 million with a 50-year term at June 30, 2007, compared to a total of 27 loans for $11.0 million at June 30, 2006.

As of June 30, 2007, the Bank had $87.4 million in mortgage loans that are subject to negative amortization, $12.6 million of which were single-family loans. This compares to $95.4 million at June 30, 2006, with $20.7 million of single-family loans. Negative amortization involves a greater risk to the Bank. During a period of high interest rates, the loan principal balance may increase by up to 115% of the original loan amount. Borrower demand for ARM loans versus fixed-rate mortgage loans is a function of the level of interest rates, the expectations of changes in the level of interest rates and the difference between the initial interest rates and fees charged for each type of loan. The relative amount of fixed-rate mortgage loans and ARM loans that can be originated at any time is largely determined by the demand for each in a given interest rate and competitive environment.

The retention of ARM loans, rather than fixed-rate loans, helps to reduce exposure to changes in interest rates. There are, however, unquantifiable credit risks resulting from the potential of increased interest charges to be paid by the borrower as a result of increases in interest rates or the expiration of interest-only periods. It is possible that, during periods of rising interest rates, the risk of default on ARM loans may increase as a result of the increase in the required payment from the borrower. Furthermore, the risk of default may increase because ARM loans originated

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by the Bank occasionally provide, as a marketing incentive, for initial rates of interest below those rates that would apply if the adjustment index plus the applicable margin were initially used for pricing. Such loans are subject to increased risks of default or delinquency. Additionally, while ARM loans allow the Bank to decrease the sensitivity of its assets as a result of changes in interest rates, the extent of this interest sensitivity is limited by the periodic and lifetime interest rate adjustment limits. In addition to fully amortizing ARM loans, the Bank has interest-only ARM loans, which typically have a fixed interest rate for the first three to five years, followed by a periodic adjustable interest rate, coupled with an interest only payment of three to ten years, followed by a fully amortizing loan payment for the remaining term. As of June 30, 2007 and 2006, interest-only, first trust deed, ARM loans were $616.5 million and $638.5 million, or 45.2% and 50.1%, respectively, of the loans held for investment. Furthermore, because loan indexes may not respond perfectly to market interest rates, upward adjustments on loans may occur more slowly than increases in the Bank's cost of interest-bearing liabilities, especially during periods of rapidly increasing interest rates. Because of these characteristics, the Bank has no assurance that yields on ARM loans will be sufficient to offset increases in the Bank's cost of funds.

The following table describes certain credit risk characteristics of the Corporation's single-family, first trust deed, mortgage loans held for investment as of June 30, 2007:

(Dollars in Thousands)	**Outstanding Balance (1)**	**Weighted-Average FICO (2)**	**Weighted-Average LTV (3)**	**Weighted-Average Seasoning (4)**
Interest only	$ 616,486	733	74%	1.78 years
Stated income (5)	$ 444,077	730	73%	1.89 years
FICO less than or equal to 660	$ 26,843	641	72%	2.42 years
Over 30-year amortization	$ 30,289	737	69%	2.16 years

(1) The outstanding balance presented on this table may overlap more than one category.
(2) The FICO score represents the credit worthiness, as reported by an independent third party, of a borrower based on the borrower's credit history. A higher FICO score indicates a greater degree of creditworthiness.
(3) LTV (loan-to-value) is the ratio calculated by dividing the original loan balance by the original appraised value of the real estate collateral.
(4) Seasoning describes the number of years since the funding date of the loan.
(5) Stated income is defined as a borrower provided level of income which is not subject to verification during the loan origination process.

The Bank's lending policy generally limits loan amounts for conventional first trust deed loans to 97% of the appraised value or purchase price of a property, whichever is lower. Higher loan-to-value ratios are available on certain government-insured or investor programs. The Bank generally requires private mortgage insurance on first trust deed residential loans with loan-to-value ratios exceeding 80% at the time of origination.

Multi-Family and Commercial Real Estate Mortgage Loans. At June 30, 2007, multi-family mortgage loans were $330.2 million and commercial real estate loans were $147.5 million, or 23.9% and 10.7%, respectively, of loans held for investment. Consistent with its strategy to diversify the composition of loans held for investment, the Bank has made the origination and purchase of multi-family and commercial real estate loans a priority. At June 30, 2007, the Bank had 408 multi-family and 181 commercial real estate loans in loans held for investment.

Multi-family mortgage loans originated by the Bank are predominately adjustable rate loans, including 3/1, 5/1 and 10/1 hybrids, with a term to maturity of 10 to 30 years based on a 25- to 30-year amortization schedule. Commercial real estate loans originated by the Bank are also predominately adjustable rate loans, including 3/1 and 5/1 hybrids, with a term to maturity of 10 years and a 25-year amortization schedule. Rates on multi-family and commercial real estate ARM loans generally adjust monthly, quarterly, semi-annually or annually at a specific margin over the respective interest rate index, subject to annual payment caps and life-of-loan interest rate caps. At June 30, 2007, $208.9 million, or 63.3%, of the Bank's multi-family loans were secured by five to 36 unit projects and were primarily located in Los Angeles, Orange, Riverside, San Bernardino and San Diego Counties. The Bank's commercial real estate loan portfolio generally consists of loans secured by small office buildings, light industrial centers, mini warehouses and small retail centers, primarily located in Southern California. The Bank originates multi-family and commercial real estate loans in amounts typically ranging from $350,000 to $4.0 million. At June 30, 2007, the Bank had 69 commercial real estate and multi-family loans with principal balances

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greater than $1.5 million totaling $176.4 million, all of which were performing in accordance with their terms as of June 30, 2007. Independent appraisers, engaged by the Bank, perform appraisals on properties that secure multi-family and commercial real estate loans. Underwriting of multi-family and commercial real estate loans includes, among other considerations, a thorough analysis of the cash flows generated by the property to support the debt service and the financial resources, experience and income level of the borrowers.

Multi-family and commercial real estate loans afford the Bank an opportunity to receive higher interest rates than those generally available from single-family mortgage loans. However, loans secured by such properties are generally greater in amount, more difficult to evaluate and monitor and are more susceptible to default as a result of general economic conditions and, therefore, involve a greater degree of risk than single-family residential mortgage loans. Because payments on loans secured by multi-family and commercial properties are often dependent on the successful operation and management of the properties, repayment of such loans may be impacted by adverse conditions in the real estate market or the economy. The multi-family and commercial real estate loans are primarily located in Los Angeles, Orange, Riverside, San Bernardino and San Diego Counties. At June 30, 2007, the Bank did not have any non-accrual multi-family or commercial real estate loans or any multi-family or commercial real estate loans that were 60 days or more past due.

Construction Mortgage Loans. The Bank originates two types of residential construction loans: short-term construction loans and construction/permanent loans. At June 30, 2007, the Bank's construction loans (gross of undisbursed loan funds) were $60.6 million, or 4.4% of loans held for investment, a decrease of $88.9 million, or 59.5%, during fiscal 2007. Undisbursed loan funds at June 30, 2007 and 2006 were $23.1 million and $75.3 million, respectively. The decrease in construction loans was primarily attributable to the management decision to reduce tract construction loan originations (given recent unfavorable real estate market conditions). Also, the decrease was attributable to loan payoff, construction completion and lower demand. Total loan payoff during fiscal 2007 was $76.8 million, gross of undisbursed loan funds and total construction completion (converted to permanent loans) during fiscal 2007 were $24.5 million. Total loan originations declined $105.6 million (gross, including undisbursed loan funds), or 88%, to $14.3 million in fiscal 2007 from $119.9 million in fiscal 2006.

The composition of the Bank's construction loan portfolio is as follows:

	At June 30,			
	2007		2006	
(Dollars In Thousands)	Amount	Percent	Amount	Percent
Short-term construction	$ 54,251	89.57%	$ 110,726	74.06%
Construction/permanent	6,320	10.43	38,791	25.94
	$ 60,571	100.00%	$ 149,517	100.00%

Short-term construction loans include three types of loans: custom construction, tract construction, and speculative construction. Additionally, the Bank makes short-term (18 to 36 month) lot loans to facilitate land acquisition prior to the start of construction. The Bank also provides construction financing for multi-family and commercial real estate properties. As of June 30, 2007 total multi-family construction loans were $4.4 million with undisbursed loan funds of $341,000; while total commercial real estate construction loans were $3.8 million with undisbursed loan funds of $2.6 million.

Custom construction loans are made to individuals who, at the time of application, have a contract executed with a builder to construct their residence. Custom construction loans are generally originated for a term of 12 months, with adjustable interest rates at the prime lending rate plus a margin and with loan-to-value ratios of up to 80% of the appraised value of the completed property. The owner secures long-term permanent financing at the completion of construction. At June 30, 2007, custom construction loans were $18.7 million, with undisbursed loan funds of $6.6 million. The custom construction loans include 23 individual construction loans in a single-family construction project located in Coachella, California. These 23 loans, with a disbursed total of $5.0 million, were placed on non-

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accrual status in December 2006 and have a specific loan loss reserve of $2.6 million. The reserve was established because financial viability of the project is uncertain. The Bank believes that the loans were fraudulently obtained and has filed lawsuits alleging loan fraud by the 23 individual borrowers, misrepresentation fraud by the mortgage loan broker and misuse of funds fraud by the contractor. Given the number of parties involved, the complexity of the transaction and probable fraud, this matter may not be resolved quickly. Additionally, it is far from certain the amount, if any, that the Bank may recover.

The Bank makes tract construction loans to subdivision builders. These subdivisions are usually financed and built in phases. A thorough analysis of market trends and demand within the area are reviewed for feasibility. Generally, significant presales are required prior to commencement of construction. Tract construction may include the building and financing of model homes under a separate loan. The terms for tract construction loans range from 12 to 18 months with interest rates floating from 1.0% to 2.0% above the prime lending rate. At June 30, 2007, tract construction loans were $18.9 million, with undisbursed loan funds of $8.5 million.

Speculative construction loans are made to home builders and are termed "speculative" because the home builder does not have, at the time of loan origination, a signed contract with a home buyer who has a commitment for permanent financing with either the Bank or another lender for the finished home. The home buyer may be identified during or after the construction period. The builder may be required to debt service the speculative construction loan for a significant period of time after the completion of construction until the homebuyer is identified. At June 30, 2007, speculative construction loans were $14.8 million, with undisbursed loan funds of $5.0 million.

Construction/permanent loans automatically roll from the construction to the permanent phase. The construction phase of a construction/permanent loan generally lasts nine to 12 months and the interest rate charged is generally floating at prime or above and with a loan-to-value ratio of up to 80% of the appraised value of the completed property.

Construction loans under $1.0 million are approved by Bank personnel specifically designated to approve construction loans. The Bank's Loan Committee, comprised of the Chief Executive Officer, Chief Lending Officer, Chief Financial Officer, Senior Vice President - PBM, and Vice President - Loan Administration, approves all construction loans over $1.0 million. Prior to approval of any construction loan, an independent fee appraiser inspects the site and the Bank reviews the existing or proposed improvements, identifies the market for the proposed project, and analyzes the pro forma data and assumptions on the project. In the case of a tract or speculative construction loan, the Bank reviews the experience and expertise of the builder. After the Bank expresses an interest in the project, the application is processed, which includes obtaining credit reports, financial statements and tax returns on the borrowers and guarantors, an independent appraisal of the project, and any other expert report necessary to evaluate the proposed project. In the event of cost overruns, the Bank requires the borrower to deposit their own funds into a loan-in-process account, which the Bank disburses consistent with the completion of the subject property pursuant to a revised disbursement schedule.

The construction loan documents require that construction loan proceeds be disbursed in increments as construction progresses. Disbursements are based on periodic on-site inspections by independent fee inspectors and Bank personnel. At inception, the Bank also requires borrowers to deposit funds into the loan-in-process account covering the difference between the actual cost of construction and the loan amount. The Bank regularly monitors the construction loan portfolio, economic conditions and housing inventory. The Bank's property inspectors perform periodic property inspections. The Bank believes that the internal monitoring system helps reduce many of the risks inherent in its construction loans.

Construction loans afford the Bank the opportunity to achieve higher interest rates and fees with shorter terms to maturity than its single-family mortgage loans. Construction loans, however, are generally considered to involve a higher degree of risk than single-family mortgage loans because of the inherent difficulty in estimating both a property's value at completion of the project and the cost of the project. The nature of these loans is such that they are generally more difficult to evaluate and monitor. If the estimate of construction costs proves to be inaccurate, the Bank may be required to advance funds beyond the amount originally committed to permit completion of the project. If the estimate of value upon completion proves to be inaccurate, the Bank may be confronted with a

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project whose value is insufficient to assure full repayment. Projects may also be jeopardized by disagreements between borrowers and builders and by the failure of builders to pay subcontractors. Loans to builders to construct homes for which no purchaser has been identified carry additional risk because the payoff for the loan depends on the builder's ability to sell the property prior to the time that the construction loan matures. The Bank has sought to address these risks by adhering to strict underwriting policies, disbursement procedures and monitoring practices. In addition, because the Bank's construction lending is in it