

CB BANCSHARES INC/HI

Form 10-K/A

November 07, 2003

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

**FORM 10-K**  
AMENDMENT NO. 1

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

For the fiscal year ended December 31, 2002

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OF 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 [NO FEE REQUIRED]

Commission File Number 0-12396

**CB BANCSHARES, INC.**

(Exact name of registrant as specified in its charter)

Hawaii  
(State of Incorporation)

99-0197163  
(IRS Employer Identification No.)

201 Merchant Street Honolulu, Hawaii 96813  
(Address of principal executive offices)

(Registrant's Telephone Number) (808) 535-2500

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

Securities registered pursuant to Section 12(g) of the Act:  
Common Stock, Par value \$1.00 per share

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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (Section 229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

The aggregate market value of registrant's Common Stock held by non-affiliates at June 28, 2002 was approximately \$142,141,000. As of January 31, 2003, registrant had outstanding 3,898,580 shares of common stock.

**DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the Proxy Statement for the annual meeting of shareholders to be held on April 24, 2003 are incorporated by reference into Part III and IV.



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**EXPLANATORY NOTE**

This Amendment No. 1 to the Annual Report on Form 10-K for CB Bancshares, Inc. (the Company) for the fiscal year ended December 31, 2002 as filed with the Securities and Exchange Commission on March 12, 2003 is being filed to amend the text of Item 1 and Item 7 and Notes A, I and N to the Consolidated Financial Statements included as part of Item 8 of the Company's 10-K as follows:

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

to include additional disclosure related to the segment information in the Business, Management's Discussion and Analysis and in Note V to the Consolidated Financial Statements;

to include additional disclosure on loan risks under the caption Loan Portfolio in the Management's Discussion and Analysis section;

to include additional disclosure on the provision and allowance for credit losses under the captions Critical Accounting Policies and Estimates and Provision and Allowance for Credit Losses in the Management's Discussion and Analysis section;

to include additional disclosures related to derivative instruments in Notes A and N of Notes to the Consolidated Financial Statements;

to include additional disclosure related to interest on non-accrual loans under the caption Risk Elements in Lending Activities in the Management's Discussion and Analysis section; and

to include additional disclosure related to long-term debt under Note I of Notes to the Consolidated Financial Statements.

In addition, in connection with the filing of this Amendment and pursuant to the rules of the Securities and Exchange Commission, the Company is including with this Amendment certain currently dated certifications. The exhibit list to this Amendment is amended to reflect the previously filed exhibits to the Company's 10-K and, therefore, unless otherwise indicated those exhibits are not re-filed herewith. The remaining disclosures contained within this Amendment consist of all other disclosures originally contained in the Company's Annual Report on Form 10-K for the year ended December 31, 2002 in the form filed with the Securities and Exchange Commission on March 12, 2003. These other disclosures as originally included in the Company's 10-K are not amended hereby, but are included for the convenience of the reader. In order to preserve the nature and character of the disclosures set forth in such disclosures as originally filed, except as expressly noted herein, this report contains disclosures as of the date of the original filing, and the Company has not updated the disclosures in this report to reflect events subsequent to the original filing date, March 12, 2003. While this report primarily relates to the historical periods covered, events may have taken place since the original filing that might have been reflected in this report if they had taken place prior to the original filing date.

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### **FORWARD-LOOKING STATEMENTS**

This Annual Report on Form 10-K includes forward-looking statements within the meaning of the Securities Exchange Act of 1934, as amended by the Private Securities Litigation Reform Act of 1995. All statements, other than statements of historical facts, included in this report that address results or developments that CB Bancshares, Inc. (the Company) expects or anticipates will or may occur in the future, where statements are preceded by, followed by or included the words believes, plans, intends, expects, anticipates or similar expressions, including such things as: (i) business strategy; (ii) economic trends and market condition, particularly in Hawaii; (iii) the direction of interest rates and prepayment speeds of mortgage loans and mortgage-backed securities; (iv) the adequacy of the Company's allowances for credit and real estate losses based on credit risks inherent in the lending processes; (v) expansion and growth of the Company's business and operations; (vi) renewal of existing credit agreements with and availability of additional advances from the Federal Home Loan Bank of Seattle (the FHLB); and (vii) other matters are forward-looking statements. These statements are based upon certain assumptions and analyses made by the Company in light of its experience and its perception of historical trends, current conditions and expected future developments as well as other factors it believes are appropriate in the circumstances. These statements are subject to a number of risks and uncertainties, many of which are beyond the control of the Company, including international, national and local economic, market or business conditions; real estate market conditions, particularly in Hawaii; the opportunities (or lack thereof) that may be presented to and pursued by the Company; competitive actions by other companies; changes in laws and regulations; the effects of natural disasters, terrorist acts and wars; and other factors. Actual results could differ materially from those contemplated by these forward-looking statements. Consequently, all of the forward-looking statements made in this report are qualified by these cautionary statements and there can be no assurance that the actual results or developments anticipated by the Company will be realized or, even substantially realized, and that they will have the expected consequences to or effects on the Company and its business or operations. Forward-looking statements made in this report speak as of the date hereof. The Company undertakes no obligation to update or revise any forward-looking statement in this report.

## **PART I**

### **ITEM 1. BUSINESS**

#### **CB BANCSHARES, INC.**

CB Bancshares, Inc. is a bank holding company which was incorporated in the State of Hawaii in 1980. As a bank holding company, the Company has the flexibility to directly or indirectly engage in certain bank-related activities other than banking, subject to regulation by the Board of Governors of the Federal Reserve System (the Federal Reserve Board or FRB). The Company has three wholly-owned subsidiaries, City Bank (the Bank), Datatronix Financial Services, Inc. (Datatronix) and O.R.E., Inc. (inactive), which are discussed below.

On July 1, 2000, International Savings and Loan Association, Limited (the Association), a wholly-owned subsidiary of the Company, merged with the Bank.

#### **CITY BANK**

City Bank is a state-chartered bank organized under the laws of the State of Hawaii in 1959. The Bank is insured by the Federal Deposit Insurance Corporation (the FDIC), and provides full commercial banking services through 17 branches on the island of Oahu, 1 branch on the island of Hawaii, 2 branches on the island of Maui and 1 branch on the island of Kauai. These services include receiving demand, savings and time deposits; making commercial, real estate and consumer loans; financing leases; financing international trade activities; issuing letters of credit; handling domestic and foreign collections; selling travelers checks and bank money orders; and renting safe deposit boxes.

The Bank's primary focus has been corporate lending to small- to medium-sized businesses by maintaining relationships and expertise within business segments and providing personal customer service. Efforts will continue to develop and enhance the expertise of the corporate sales force and to leverage these corporate relationships to generate core deposit growth. The Bank also has restructured in order to link the corporate and wholesale lending to the retail banking group with the intent of developing seamless service between the corporate loan officers and the branch personnel and to increase cross-sale opportunities between business and retail customers. The Bank has commenced implementing its customer relationship management program which it believes will significantly enhance this effort.

The Bank also plans to further develop its electronic banking activities by continuing to enhance internet banking capability for both business and retail customers.

#### **DATATRONIX FINANCIAL SERVICES, INC.**

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Datatronix, a wholly-owned subsidiary, was incorporated in the State of Hawaii in June 2000. Datatronix offers item processing services to banks, thrifts, credit unions and other financial institutions in the State of Hawaii and California. As of December 31, 2002, Datatronix had three customers, with the Bank as its primary customer.

### **BUSINESS SEGMENTS**

The Company's business segments are defined as Retail Banking, Wholesale Banking, Treasury and All Others. Retail Banking is made up of retail deposits, mortgage banking and consumer lending activities. Wholesale Banking consists of wholesale deposits, commercial real estate lending, corporate lending and the specialized lending functions of the Bank. The Treasury segment is responsible for managing the Company's investment securities portfolio and borrowing. The All Other segment consists of the administrative support of the Bank, transactions of CB Bancshares, Inc. (the Parent Company), and subsidiaries of the Parent Company and Bank. Additional financial and other information about the Company's business segments is presented in the Segments Discussion section of Management's Discussion and Analysis of Financial Condition and Results of Operations ( MD&A ) and Note V of Notes to the Consolidated Financial Statements.

### **FHLB BORROWINGS**

A primary source of borrowings for the Company is advances from the FHLB. The Bank has credit line agreements allowing for both short- and long-term advances. The agreements permit the Bank to borrow up to 35% of total qualified assets, provided that adequate mortgage loans or investment securities are pledged as collateral. At December 31, 2002, the Company had \$10.0 million in short-term advances from the FHLB maturing in March 2003 with a rate of 1.87% and \$319.4 million in long-term advances from the FHLB ranging in maturity from May 2003 to September 2014 and rates from 1.22% to 8.22%. Advances are priced at the date of advance as either fixed or LIBOR-based. See



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the Liquidity section of Management's Discussion and Analysis as well as Notes H and I of Notes to the Company's Consolidated Financial Statements for further information.

### **COMPETITION AND ECONOMIC ENVIRONMENT**

The earnings and growth of the Company and its subsidiaries are affected by the changes in the monetary and fiscal policies of the United States (the U.S.), as well as by local, national and international economic conditions. The overall growth of loans and investments, deposit levels and interest rates are directly influenced by the monetary policies of the Federal Reserve System. Since these changes are generally unpredictable, it is difficult to ascertain the impact of such future changes on the operations of the Company and its subsidiaries.

The banking business is highly competitive. The Bank competes for deposits and loans with five other commercial banks (The Bank is the fourth largest of the five commercial banks) and two other savings associations located in Hawaii. In addition to other commercial banks and savings associations, the Bank competes for savings and time deposits and certain types of loans with other financial institutions, such as consumer finance companies, credit unions, merchandise retailers, and a variety of financial service and advisory companies. The Bank also competes for mortgage loans with insurance and mortgage companies.

The economy of Hawaii is supported principally by tourism, governmental expenditures (primarily for the military), construction, and agriculture. The government has made certain strides in attempting to broaden the state's economic base in the areas of diversified agriculture, biotechnology, information technology and film. A small island economy like that of Hawaii, which significantly depends on imports for consumption, is greatly influenced by the changes in external economic conditions. A key to the economic performance of the state is the health of the U.S. and Japan economies and, to a lesser extent, the economies of Canada, Europe and other Asian nations. With the continued global instability and geopolitical issues in the Middle East and Asia, the Hawaii economy and many businesses are vulnerable to another economic downturn.

The events of September 11, 2001 have had a significant negative impact on the world, U.S. and Hawaii economies. Due to its dependence on tourism, Hawaii has been significantly affected by these events. However, during 2002, the state's tourism industry showed slight improvement over 2001. Total visitor arrivals were up 0.9% and total visitor days increased by 2.8%. Japanese visitor arrivals were down 4.3% in 2002, compared to the 15.9% decrease reported in 2001. Defense procurement contracts totaled \$1.4 billion, an increase of 9.6% from 2001 to 2002. State government expenditure on capital improvement projects increased by 7.1% in 2002 from 2001. At December 31, 2002, Hawaii's unemployment rate was 3.6%, an improvement over the 5.0% reported a year ago. This coincided with the increase of real personal income by approximately 3.7% over this same period. Another sector showing improvement in 2002 was the state's housing market, supported by low mortgage interest rates. Residential home sales in 2002 were \$2.6 billion, compared to \$2.0 billion in 2001. The 2002 median sales price for single family homes and condominiums increased by 11.7% and 14.3%, respectively and construction jobs grew by 3.9% in 2002. The total population of the State of Hawaii grew by 1.5% from 2001 to 2002.

### **REGULATORY CONSIDERATIONS**

The following discussion sets forth certain elements of the regulatory framework applicable to the Company. Federal and state regulation of financial institutions is intended primarily for the protection of depositors rather than shareholders of those entities. To the extent that the following discussion describes statutory or regulatory provisions, it is not intended to be complete and is qualified in its entirety by reference to the particular statutory or regulatory provisions, and any case law or interpretive letters concerning such provisions. In addition, there are other statutes and regulations that apply to and regulate the operation of the Company and its subsidiaries. Any change in applicable laws, or regulations, may have a material or possibly adverse effect on the business of the Company or other subsidiaries of the Company.

**Bank Holding Company.** The Company is a bank holding company subject to supervision and regulations by the FRB under the Bank Holding Company Act of 1956, as amended (the BHCA). As a bank holding company, the Company's activities and those of its banking and non-banking subsidiaries are limited to the business of banking and activities closely related or incidental to banking and to certain expressly permitted nonbanking activities. In addition, with certain exceptions, the Company may not acquire, directly or indirectly, more than 5% of any class of the voting shares of, or substantially all of the assets of, a bank or any other company without the prior approval of the FRB.

**The Bank.** The Bank is organized under the laws of the State of Hawaii and is subject to significant regulations by the FDIC and the State of Hawaii Division of Financial Institutions of the Department of Commerce and Consumer Affairs. The Bank is also subject to significant federal and state regulations which materially affects its operations.

**The Community Reinvestment Act.** The Community Reinvestment Act (the CRA) requires lenders to identify the communities served by the Company's offices and to identify the types of credit the institution is prepared to extend within such communities. Under the CRA regulations of the FDIC and the other federal banking agencies, an institution's performance in making loans and investments and maintaining branches and providing services in low- and moderate-income areas within the communities that it serves is evaluated. In connection with its assessment of

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CRA performance, the FDIC assigns a rating of outstanding, satisfactory, needs to improve, or substantial noncompliance.

**The Federal Home Loan Banks.** Under the Federal Home Loan Bank Act, as amended, the ongoing stock investment requirement is equal to 0.3% of total assets, 1% of residential mortgages and mortgage-backed securities, or 5% of advances divided by the institution's Qualifying Assets Ratio ( QAR ), whichever is higher. The institution's QAR will determine a ratio of stock to borrowings (the higher the QAR, the lower the stock to borrowings requirement). The stock is recorded as a restricted investment security at par. Furthermore, FHLB advances must be collateralized with certain types of assets. Accordingly, the Company has pledged certain investments and loans to the FHLB as collateral for its advances.

**Dividend Restrictions.** The principal source of the Company's cash flow has been dividend payments received from the Bank. Dividends paid to the Company by the Bank totaled \$5.8 million and \$6.3 million in 2002 and 2001, respectively. Under the laws of Hawaii, payment of dividends by the Bank is subject to certain restrictions, and payment of dividends by the Company is likewise subject to certain restrictions.

The Company will continue to evaluate the dividend on a quarterly basis. In addition, applicable regulatory authorities are authorized to prohibit banks, thrifts and their holding companies from paying dividends which would constitute an unsafe and unsound banking practice.

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The FRB has indicated that it would generally be an unsafe and unsound banking practice for banks to pay dividends except out of current operating earnings. Furthermore, an insured depository institution, such as the Bank, cannot make a capital distribution (broadly defined to include, among other things, dividends, redemptions and other repurchases of stock), or pay management fees to its holding company if, thereafter, the depository institution would be undercapitalized.

**Capital Standards.** The Company and the Bank are subject to capital standards promulgated by the FRB, the FDIC, and the Hawaii Division of Financial Institutions. The minimum ratio of total capital to risk-weighted assets, provided for in the guidelines adopted by the FRB, including certain off-balance-sheet items such as standby letters of credit, is 8%. At least half of the total capital is to be comprised of common equity, retained earnings, non-cumulative perpetual preferred stock, and a limited amount of cumulative perpetual preferred stock less goodwill ( Tier 1 Capital ). The remainder may consist of a limited amount of subordinated debt, other preferred stock, certain other instruments, and a limited amount of reserves for loan losses ( Tier 2 Capital ). The FDIC's risk-based capital guidelines for state non-member banks of the Federal Reserve System are generally similar to those established by the FRB for bank holding companies.

The FRB and FDIC also have adopted minimum leverage ratios for bank holding companies and banks requiring bank organizations to maintain a Leverage Ratio (defined as Tier 1 Capital divided by average total assets less goodwill) of at least 4% of total assets. The most highly rated banking organizations are expected to maintain an additional cushion of at least 100 basis points (1% equals 100 basis points), taking into account the level and nature of risk, to be allocated to the specific banking organizations by the primary regulator.

FRB guidelines also provide that banking organizations experiencing internal growth or making acquisitions will be expected to maintain strong capital positions substantially above the minimum supervisory levels, without significant reliance on intangible assets. Furthermore, the guidelines indicate that the FRB will continue to consider a tangible Tier 1 leverage ratio in evaluating proposals for expansion or new activities. The tangible Tier 1 leverage ratio is the ratio of a banking organization's Tier 1 Capital, less intangibles, to total assets, less intangibles.

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Failure to meet capital guidelines could subject a bank to a variety of enforcement remedies, including the termination of deposit insurance by the FDIC, and to certain restrictions on its business, including restricting the payment of dividends. At December 31, 2002, the Company and the Bank exceeded applicable capital requirements. The consolidated capital position of the Company at December 31, 2002 was as follows:

	<u>Company ratio</u>	<u>Minimum required ratio</u>
Risk-based Capital:		
Tier 1 capital ratio	12.19%	4.00%
Total capital ratio	13.46%	8.00%
Leverage ratio	9.03%	4.00%

Under FRB regulations, a bank holding company is required to serve as a source of financial and managerial strength to its subsidiary banks and may not conduct its operations in an unsafe or unsound manner. In addition, it is the FRB's policy that in serving as a source of strength to its subsidiary banks, a bank holding company should stand ready to use available resources to provide adequate capital funds to its subsidiary banks during periods of financial stress or adversity and should maintain the financial flexibility and capital-raising capacity to obtain additional resources for assisting its subsidiary banks. A bank holding company's failure to meet its obligations to serve as a source of strength to its subsidiary banks will generally be considered by the FRB to be an unsafe and unsound banking practice or a violation of the FRB regulations, or both. Any capital loans by a bank holding company to any of its subsidiary banks are subordinate in right of payment to deposits and to certain other indebtedness of such subsidiary bank. Moreover, Congress has passed legislation pursuant to which depositors are granted a preference over all other unsecured creditors in the event of the insolvency of a bank or thrift.

**Affiliate Transactions.** Unless an exemption applies, sections 23A and 23B of the Federal Reserve Act and Regulation W thereunder (i) limit the extent to which a financial institution or its subsidiaries may engage in covered transactions with an affiliate, to an amount equal to 10% of such institution's capital and surplus and an aggregate limit on all such transactions with all affiliates to an amount equal to 20% of such capital and surplus and (ii) require that all transactions with an affiliate be on terms substantially the same, or at least as favorable to the institution or subsidiary, as those provided to a non-affiliate. The term covered transaction includes the making of loans, purchase of assets, issuance of a guarantee and other similar types of transactions.

**Safety and Soundness.** The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) requires each federal banking regulatory agency to prescribe, by regulation, standards for all insured depository institutions and depository institution holding companies relating to: (i) internal controls, information systems and audit systems; (ii) loan documentation; (iii) credit underwriting; (iv) interest rate risk exposure; (v) asset growth; (vi) compensation, fees and benefits; and (vii) such other operational and managerial standards as the agency determines to be appropriate. The compensation standards would prohibit employment contracts, compensation or benefit arrangements, stock option plans, fee arrangements or other compensatory arrangements that provide excessive compensation, fees or benefits or could lead to material financial loss. In addition, each federal banking regulatory agency must prescribe by regulation standards specifying: (i) a maximum ratio of classified assets to capital; (ii) minimum earnings sufficient to absorb losses without impairing capital to the extent feasible; (iii) a minimum ratio of market value to book value for publicly traded shares of depository institutions and depository institution holding companies; and (iv) such other standards relating to asset quality, earnings and valuation as the agency determines to be appropriate. If an insured depository institution or its holding company fail to meet any of the standards promulgated by regulations, then such company will be required to submit a plan to its federal regulator specifying the steps it will take to correct the deficiency. The federal banking agencies have uniform rules concerning these standards.

**Prompt Corrective Action.** Under FDICIA, each federal banking agency is required to take prompt corrective action to resolve the problems of insured depository institutions that do not meet minimum capital ratios. The extent of an agency's power to take prompt corrective action depends upon whether an institution is well-capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, or critically undercapitalized.

The federal banking agencies have adopted regulations to implement the prompt corrective action provisions of FDICIA. Under the regulations, an institution shall be deemed to be: (i) well-capitalized if it has total risk-based capital of 10% or more, has a Tier 1 risk-based capital ratio of 6% or more, has a Tier 1 leverage capital ratio of 5% or more and is not subject to any written agreement, order or directive to meet and maintain a specific capital level for any capital measure; (ii) adequately capitalized if it has a total risk-based capital ratio of 8% or more, a Tier 1 risk-based capital ratio of 4% or more and a Tier 1 leverage capital ratio of 4% or more (3% under certain circumstances) and does not meet the definition of well-capitalized; (iii) undercapitalized if it has a total risk-based capital ratio that is less than 8%, a Tier 1 risk-based capital ratio of 4% or more or a Tier 1 leverage capital ratio that is less than 4% (3% under certain circumstances); (iv) significantly undercapitalized if it has a total risk-based capital ratio that is less than 6%, a Tier 1 risk-based capital ratio that is less than 3% or a Tier 1 leverage capital ratio that is less than 3%; and (v) critically undercapitalized if it has a ratio of tangible equity to total assets that is equal to or less than 2%.

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FDICIA authorizes the appropriate federal banking agency, after notice and an opportunity for a hearing, to treat an insured depository institution as if it had a lower capital-based classification if it is in an unsafe or unsound condition, engages in an unsafe or unsound practice or receives an unsatisfactory examination rating. Thus, a well-capitalized institution could be subjected to the restrictions of undercapitalized institutions.

An undercapitalized institution is required to submit an acceptable capital restoration plan to its appropriate federal banking agency. The plan must specify: (i) the steps the institution will take to become adequately capitalized; (ii) the capital levels to be attained each year; (iii) how the institution will comply with any regulatory sanctions then in effect against the institution; and (iv) the types and levels of activities in which the institution will engage. An undercapitalized institution is also generally prohibited from paying any management fee or dividends to its holding company, increasing its average total assets and is generally prohibited from making any acquisitions, establishing any new branches or engaging in any new line of business except in accordance with an accepted capital restoration plan or with the approval of the FDIC.

The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (the IBBEA ) amended the BHCA to create certain interstate banking and branching opportunities. Under the IBBEA, a bank holding company may acquire a bank located in any state, provided that the acquisition does not result in the bank holding company controlling more than 10% of the deposits in insured depository institutions in the

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United States, or 30% of deposits in insured institutions in the state in which the bank to be acquired is located (unless the state waives the 30% deposit limitation or it is the initial entry into the state). The IBBEA permits individual states to restrict the ability of an out-of-state bank holding company or bank to acquire an in-state bank that has been in existence for less than five years and to establish a state concentration limit of less than 30% if such reduced limit does not discriminate against out-of-state bank holding companies or banks.

The IBBEA authorizes an adequately-capitalized bank, with the approval of the appropriate federal banking agency, to merge with another adequately-capitalized bank in any state that has not opted out of interstate branching. Such a bank may operate the target's offices as branches if certain conditions are satisfied. The same national and state deposit concentration limits and applicable state minimum-existence restrictions which apply to interstate acquisitions (as discussed above) also apply to interstate mergers. The applicant also must comply with any non-discriminatory host state filing and notice requirements and demonstrate a record of compliance with applicable federal and state community reinvestment laws. Hawaii enacted an interstate branching and bank mergers law which expressly permits interstate branching under Sections 102 and 103 of the IBBEA.

Under the IBBEA, the resulting bank in an interstate merger may establish or acquire additional branches at any location in a state where any of the banks involved in the merger could have established or acquired a branch. A bank also may acquire one or more branches of an out-of-state bank without acquiring the target out-of-state bank if the law of the target's home state permits such a transaction. In addition, the IBBEA permits a bank to establish a de novo branch in another state if the host state statutorily permits de novo interstate branching.

Hawaii law authorizes out-of-state banks to engage in interstate merger transactions (mergers and consolidations with and purchases of all or substantially all of the assets and branches of) with Hawaii banks, following which any such out-of-state bank may operate the branches of the Hawaii bank it has acquired. The Hawaii bank must have been in continuous operation for at least five years prior to such an acquisition, unless it is subject to or in danger of becoming subject to certain types of supervisory action. This statute does not permit out-of-state banks to acquire branches of Hawaii banks other than through an interstate merger transaction (except in the case of a bank that is subject to or in danger of becoming subject to certain types of supervisory action) nor to open branches in Hawaii on a de novo basis. Hawaii law imposes no state deposit caps or concentration limits. It also permits the State Commissioner of Financial Institutions to waive, on a case-by-case basis, federal statewide concentration limits, in accordance with standards that do not discriminate against out-of-state banks.

The IBBEA also permits a bank subsidiary of a bank holding company to act as agent for other depository institutions owned by the same holding company for purposes of receiving deposits, renewing time deposits, closing or servicing loans and receiving loan payments.

**Gramm-Leach Bliley Act.** The Gramm-Leach-Bliley Act (the GLB Act) revised and expanded the existing BHCA and certain sections of the 1933 Glass-Steagall Act to permit a holding company system to engage in a full range of financial activities, including but not limited to, banking, insurance, securities, merchant banking and other activities incidental to financial services. The GLB Act permits the scope of financial and incidental activities to evolve with technology and competition. It also provides expanded financial affiliation opportunities for existing bank holding companies (BHC) and allows all financial holding companies to control a full-service insured bank. These expanded permissible activities are allowable for a BHC if it becomes a financial holding company (FHC). In order to become an FHC, a BHC must file a declaration with the FRB electing to engage in activities under the new BHCA Section 4(k) and certifying that it is eligible to do so because all of its insured depository institution subsidiaries are well-capitalized and well-managed. An institution is well-capitalized if it meets the primary regulator's definition for that status under the Federal Deposit Insurance Act for prompt corrective action purposes. Additionally, the FRB must determine that each depository institution controlled by an FHC has a satisfactory or better rating under the CRA in order for a company to become an FHC or for an FHC to engage in new financial activities or acquire, directly or indirectly, a company engaged in any activity under subsection (k) or (n). The FRB will be the overall regulatory agency and, along with the Department of Treasury, will have joint oversight to determine new financial activities of FHC companies. The Company has not elected FHC status.

It is anticipated that this change in legislation will serve to provide consumers added convenience and savings as FHCs will be able to provide one-stop shops for financial services. It also provides for added privacy for consumers as policies on collecting, using and protecting personal financial information must be disclosed in writing to customers and customers will have the option to block information sharing with unaffiliated third parties, such as telemarketing companies.

**Depository Insurance.** The FDIC has a premium schedule under which the assessment rate for a bank depends upon the risk classification the FDIC assigns the institution. This allows institutions with improving capital positions to benefit from the improvement by lower assessments, while requiring those whose capital is falling to pay higher assessments. The FDIC may raise an institution's insurance premiums or terminate insurance altogether upon a finding that the institution has engaged in unsafe and unsound practices.

**Other Regulatory Considerations.** The Bank is also subject to a wide array of other state and federal laws and regulations, including, without limitation, usury laws, the Patriot Act, the Equal Credit Opportunity Act, the Electronic Funds Transfer requirements, the Truth-in-Lending Act, the Truth-in-Savings Act and the Real Estate Settlement Procedures Act.

**NUMBER OF EMPLOYEES**

As of December 31, 2002, the Company and its subsidiaries employed 512 persons, 473 on a full-time basis and 39 on a part-time basis. Neither the Company nor any of its subsidiaries are a party to any collective bargaining agreements.

**Table of Contents****STATISTICAL DISCLOSURES**

Guide 3 of the Guides for the Preparation and Filing of Reports under the Exchange Act of 1934 sets forth certain statistical disclosures to be included in the Description of Business section of bank holding company filings with the Securities and Exchange Commission (the SEC).

The statistical information required is presented in the index shown below and as part of Items 6 or 7 of this Form 10-K for the fiscal year ended December 31, 2002. The tables and information contained therein have been prepared by the Company and have not been audited or reported upon by the Company's independent accountants.

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**Table of Contents****ITEM 2. PROPERTIES**

The operations of the Bank are transacted through its main banking office and 20 other branches. The Company's facilities are located on leased premises, and expenditures by the Company for interior improvements are capitalized. The leases for these premises expire on various dates through the year 2067. Lease terms generally provide for additional payments for real property taxes, insurance and maintenance. See Note F of Notes to the Company's Consolidated Financial Statements.

**ITEM 3. LEGAL PROCEEDINGS**

The Company is a defendant in various legal proceedings arising from normal business activities. In the opinion of management, after reviewing these proceedings with counsel, the aggregate liability, if any, resulting from these proceedings would not have a material effect on the Company's consolidated financial position or results of operations.

**ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

No matter was submitted during the fourth quarter of 2002 to a vote of security holders through the solicitation of proxies or otherwise.

**PART II****ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS**

The Company's common stock is traded on the NASDAQ National Market System under the symbol CBBI. At March 1, 2003, the Company had approximately 4,000 common shareholders of record.

The following table sets forth quarterly high and low bid and dividend information on a per share basis for the Company's common stock over the preceding two years. Per share amounts have been retroactively adjusted to reflect stock dividends:

	<u>High</u>	<u>Low</u>	<u>Dividends</u>
<b>2002</b>			
<b>First quarter</b>	<b>\$33.95</b>	<b>\$30.10</b>	<b>\$0.11</b>
<b>Second quarter</b>	<b>40.64</b>	<b>33.23</b>	<b>0.11</b>
<b>Third quarter</b>	<b>39.99</b>	<b>32.86</b>	<b>0.11</b>
<b>Fourth quarter</b>	<b>43.00</b>	<b>34.92</b>	<b>0.11</b>
<b>2001</b>			
First quarter	\$28.12	\$21.04	\$0.10
Second quarter	32.24	25.97	0.11
Third quarter	34.17	27.09	0.11
Fourth quarter	31.72	28.71	0.11

The Company's ability to pay dividends is limited by certain restrictions generally imposed on Hawaii corporations. The Company may pay dividends out of funds legally available at such times as the Board of Directors determines are appropriate.

**Table of Contents****ITEM 6. SELECTED FINANCIAL DATA**

(dollars in thousands, except per share data)

	<u>2002</u>	<u>2001</u>	<u>2000</u>	<u>1999</u>	<u>1998</u>
<b>Income Statement Data:</b>					
Interest income	<b>\$ 106,945</b>	\$ 128,254	\$ 132,472	\$ 111,233	\$ 112,060
Interest expense	<b>30,292</b>	57,448	71,478	52,717	53,811
Net interest income	<b>76,653</b>	70,806	60,994	58,516	58,249
Provision for credit losses	<b>17,110</b>	13,628	7,539	4,975	7,436
Net interest income after provision for credit losses	<b>59,543</b>	57,178	53,455	53,541	50,813
Noninterest income <sup>(1)</sup>	<b>12,815</b>	2,817	10,024	10,328	9,789
Noninterest expense <sup>(2)</sup>	<b>52,618</b>	50,595	46,679	58,336	46,768
Income before income taxes	<b>19,740</b>	9,400	16,800	5,533	13,834
Income tax expense	<b>6,258</b>	3,250	5,582	5,227	5,465
Net income	<b>\$ 13,482</b>	\$ 6,150	\$ 11,218	\$ 306	\$ 8,369
Cash dividends	<b>\$ 1,649</b>	\$ 1,441	\$ 1,093	\$ 931	\$ 818
<b>End of Year Balance Sheet Data:</b>					
Total assets	<b>\$1,674,358</b>	\$1,586,040	\$1,721,602	\$1,619,549	\$1,428,438
Total earning assets	<b>1,552,936</b>	1,516,583	1,633,545	1,506,732	1,318,294
Total loans	<b>1,160,963</b>	1,242,942	1,301,358	1,152,731	1,079,297
Total deposits	<b>1,163,227</b>	1,138,435	1,218,463	1,106,145	1,084,610
Long-term debt	<b>319,407</b>	214,424	181,563	225,140	171,087
Stockholders' equity	<b>151,009</b>	133,762	123,162	114,691	132,372
<b>Average Balances:</b>					
Total assets	<b>\$1,574,396</b>	\$1,678,679	\$1,667,243	\$1,491,947	\$1,424,793
Total earning assets	<b>1,495,733</b>	1,598,964	1,583,704	1,391,681	1,343,524
Total loans	<b>1,149,100</b>	1,296,274	1,236,305	1,077,769	1,063,541
Total deposits	<b>1,133,169</b>	1,193,758	1,154,075	1,082,642	1,038,751
Long-term debt	<b>250,658</b>	235,028	205,877	205,098	168,934
Stockholders' equity	<b>144,253</b>	128,666	118,132	127,567	128,889
<b>Common Stock Data:</b>					
Per share (diluted) <sup>(3)</sup> :					
Net income	<b>\$ 3.43</b>	\$ 1.58	\$ 2.88	\$ 0.07	\$ 1.97
Cash dividends declared	<b>0.44</b>	0.43	0.34	0.27	0.23
Book value (at December 31)	<b>39.17</b>	35.07	31.84	29.15	31.28
Market price (close at December 31)	<b>42.52</b>	31.67	20.99	23.60	24.58
Average shares outstanding	<b>3,935,296</b>	3,891,973	3,898,435	4,144,672	4,238,216
<b>Selected Ratios:</b>					
Return on average:					
Total assets	<b>0.86%</b>	0.37%	0.67%	0.02%	0.59%
Stockholders' equity	<b>9.35</b>	4.78	9.50	0.24	6.49
Dividend payout ratio	<b>11.43</b>	11.46	9.74	10.22	9.77
Average stockholders' equity to average total assets	<b>9.16</b>	7.66	7.09	8.55	9.05

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Year ended December 31:

Net interest margin (taxable equivalent basis)	<b>5.18</b>	4.48	3.91	4.25	4.36
Net loans charged off to average loans	<b>0.82</b>	0.90	0.65	0.45	0.57
Efficiency ratio <sup>(4)</sup>	<b>57.37</b>	59.33	64.39	69.55	67.71
At December 31:					
Risk-based capital ratios:					
Tier I	<b>12.19</b>	11.32	12.04	11.95	13.54
Total	<b>13.46</b>	12.58	13.29	13.21	14.80
Tier I leverage ratio	<b>9.03</b>	8.31	8.01	7.69	8.65
Allowance for credit losses to total loans	<b>2.34</b>	1.57	1.34	1.56	1.65
Nonperforming assets to total loans	<b>1.29</b>	1.65	1.43	1.58	2.02
Nonperforming assets to total assets	<b>0.89</b>	1.29	1.08	1.12	1.53
Allowance for credit losses to nonperforming loans	<b>213.06</b>	123.24	115.35	152.28	133.95

- (1) **Includes impairment charges on asset-backed securities of \$1,399,000 and \$10,642,000 incurred in 2002 and 2001, respectively.**
- (2) **Includes restructuring and merger-related charges of \$1,551,000 and write-off of goodwill of \$7,873,000 incurred in 1999.**
- (3) **Common stock data retroactively adjusted for 10% stock dividend paid in 2002 and 2001.**
- (4) **Defined as noninterest expense minus amortization of intangibles as a percentage of total operating revenue (excluding impairment charges of \$1.4 million and \$10.6 million in 2002 and 2001, respectively, and restructuring and merger-related charges of \$1.6 million, and write-off of goodwill of \$7.9 million in 1999).**

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**ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

Management's Discussion and Analysis of Financial Condition and Results of Operations contains statements relating to future results of the Company (including certain projections and business trends) that are considered forward-looking statements. Actual results may differ materially from those projected as a result of certain risks and uncertainties including, but not limited to, changes in political and economic conditions, interest rate fluctuations, competitive product and pricing pressures within the Company's market, equity and bond market fluctuations, personal and corporate customers' bankruptcies and financial condition, inflation and results of litigation. Accordingly, historical performance, as well as reasonably applied projections and assumptions, may not be a reliable indicator of future earnings due to risks and uncertainties. As circumstances, conditions or events change that affect the Company's assumptions and projections on which any of the statements are based, the Company disclaims any obligation to issue any update or revision to any forward-looking statement contained herein.

**CRITICAL ACCOUNTING POLICIES AND ESTIMATES**

Management's discussion and analysis of its financial condition and results of operations are based upon the Company's consolidated financial statements, which have been prepared in accordance with generally accepted accounting principles. The preparation of these financial statements requires the Company to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. On an on-going basis, the Company evaluates its estimates, including those related to its investments, loans and allowance for loan losses, intangible assets, income taxes, contingencies, and litigation. The Company bases its estimates on current market conditions, historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. The Company believes the following critical accounting policies require significant judgments and estimates used in the preparation of its consolidated financial statements.

**Allowance for Credit Losses.** The Company's allowance for credit losses represents management's estimate of probable losses inherent in the loan portfolio. The allowance for credit losses is periodically evaluated for adequacy by management. Factors considered include the Company's loan loss experience, known and inherent risks in the portfolio, current economic conditions, known adverse situations that may affect the borrower's ability to repay, regulatory policies, and the estimated value of underlying collateral. The evaluation of the adequacy of the allowance is based on the above factors along with prevailing and anticipated economic conditions that may impact borrowers' ability to repay loans. Determination of the allowance is in part objective and in part a subjective judgment by management given the information it currently has in its possession. Adverse changes in any of these factors or the discovery of new adverse information could result in higher charge-offs and loan loss provisions.

The Allowance consists of allocated and unallocated allowances. The allocated allowance relate to specific allowances for individual loans, pooled graded loans, and homogeneous loans (consumer loans and residential mortgage loans). The Company has established and adopted a loan grading system in which loans are segregated by risk. Certain graded commercial and commercial real estate loans are analyzed on an individual basis based on performance and collateral. The allocated allowance also include a percentage factor for pooled graded and homogenous pools of loans taking into account the Bank's historical losses as well as the present condition, expected performance of each pool and risks inherent in loan concentrations in certain industries or categories.

To mitigate imprecision in the estimates of expected credit losses, the allocated component of the allowance is supplemented by an unallocated component. The unallocated allowance is more judgmental and takes into consideration the risks inherent in the loan portfolio, estimation errors, and economic trends or uncertainties that are not necessarily captured in determining allocated allowances.

**Impairment of Investments.** The realization of the Company's investment in certain mortgage/asset-backed securities and collateralized loan and bond obligations is dependent on the credit quality of the underlying borrowers and yields demanded by the marketplace. Increases in market interest rates and deteriorating credit quality of the underlying borrowers because of adverse conditions may result in additional losses. The Company records an investment impairment charge when it believes an investment has experienced a decline in value that is other than temporary. Future adverse changes in market conditions or poor operating results of underlying investments could result in losses or an inability to recover the carrying value of the investments that may not be reflected in an investment's current carrying value, thereby possibly requiring an impairment charge in the future. Since the collateralized loan and bond obligations do not have a liquid trading market, management's estimate of value is based upon estimates of future returns that may or may not actually be realized. Accordingly, under different assumptions, the value could be adversely affected. As of December 31, 2002, approximately \$34.4 million of these investments were carried on the books of the Company.

**Deferred Tax Assets.** The Company records a valuation allowance to reduce its deferred tax assets to the amount that it believes is more likely than not to be realized. This requires an objective as well as a subjective judgment by management. While the Company has considered future taxable income and ongoing prudent and feasible tax planning strategies in assessing the need for the valuation allowance, in the event the Company were to determine that it would be able to realize its deferred tax assets in the future in excess of its net recorded amount, an

adjustment to the deferred tax asset would increase income in the period such determination was made. Likewise, should the Company determine that it would not be able to realize all or part of its net deferred tax asset in the future, an adjustment to the deferred tax asset would be charged to income in the period such determination was made.

## **RESULTS OF OPERATIONS**

Consolidated net income for 2002 was \$13.5 million, an increase of \$7.3 million, or 119.2%, from 2001. Diluted earnings per share was \$3.43 in 2002, as compared to \$1.58 in 2001. All per share amounts have been restated for the effect of the 10% stock dividend paid in June 2002 and 2001. The increase was primarily due to a reduction in impairment charges, recorded in 2002 as compared to 2001, related to certain investment securities.

Net interest income was \$76.7 million for 2002, an increase of \$5.8 million, or 8.3%, compared to 2001. The increase in the net interest income was primarily due to an increase in the net interest margin, which increased to 5.18%, or 70 basis points, for 2002 and a \$42.9 million increase in net earning assets.

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Noninterest income was \$12.8 million for 2002, an increase of \$10.0 million, or 354.9%, compared to the same period in 2001. The increase was primarily due to: (i) a reduction in impairment charges related to certain securities in its investment portfolio of \$9.2 million; and (ii) an increase of \$2.4 million in service charges and fees. These items were partially offset by a decrease of \$2.2 million on gains from the sale of securities and loans.

Noninterest expense was \$52.6 million for 2002, an increase of \$2.0 million, or 4.0%, compared to 2001. The efficiency ratio (exclusive of the impairment charges and amortization of intangibles) improved from 59.86% in 2001 to 57.37% in 2002.

The provision for credit losses was \$17.1 million, \$13.6 million and \$7.5 million in 2002, 2001 and 2000, respectively. Net charge-offs to average loans and leases were 0.82%, 0.90% and 0.65% for 2002, 2001 and 2000, respectively. The allowance for credit losses was \$27.1 million, or 2.34% of total loans and leases, at December 31, 2002, compared with \$19.5 million, or 1.57%, at December 31, 2001. Nonperforming assets totaled 0.89%, 1.29% and 1.08% of total assets as of December 31, 2002, 2001 and 2000, respectively.

At December 31, 2002, the Company's ratios of Tier 1 Capital to risk-weighted assets and Total Capital to risk-weighted assets were 12.19% and 13.46%, respectively, compared with 11.32% and 12.58%, respectively, at December 31, 2001. These ratios were in excess of the well-capitalized ratios of 6.00% and 10.00%, respectively, specified by the FRB.

Consolidated net income for 2001 was \$6.2 million, a decrease of \$5.1 million, or 45.2%, from 2000. Diluted earnings per share was \$1.58 in 2001, as compared to \$2.88 in 2000. All per share amounts have been restated for the effect of the 10% stock dividend paid in June 2002 and 2001. Based on the adoption of new accounting principles in 2001, the Company recorded impairment charges of \$10.6 million (\$6.4 million after-tax) for the year ended December 31, 2001 related to certain securities in its investment portfolio. See Note A of Notes to the Company's Consolidated Financial Statements for further discussion.

Net interest income was \$70.8 million for 2001, an increase of \$9.8 million, or 16.1%, compared to 2000. The increase in the net interest income was primarily due to an increase in the net interest margin, which increased to 4.48%, or 57 basis points, for 2001 and a \$36.0 million increase in net earning assets.

Noninterest income was \$2.8 million for 2001, a decrease of \$7.2 million, or 72.0%, compared to the same periods in 2000. The decrease was primarily due to the previously mentioned \$10.6 million impairment charge, partially offset by an increase of \$1.8 million in service charges and \$1.5 million increase on gains from the sales of loans.

Noninterest expense was \$50.6 million for 2001, an increase of \$3.9 million, or 8.4%, compared to 2000. The increase was primarily due to an increase in salaries and benefits (due to higher incentive-based compensation) and an increase in other noninterest expense, partially offset by a decrease in net occupancy expense.

Consolidated net income for 2000 was \$11.2 million, an increase of \$10.9 million from the \$306,000 in 1999. In 1999, the Company recorded restructuring and merger-related charges of \$1.6 million and a write-off of goodwill of \$7.9 million (as a result of a change in accounting method).

## **NET INTEREST INCOME**

Net interest income is the largest single component of the Company's earnings and represents the difference between interest income received on loans and other earning assets and interest expense paid on deposits and borrowings. Net interest income, on a taxable equivalent basis, was \$77.5 million in 2002, an increase of \$5.8 million, or 8.2%, over 2001. During 2002, the Company's net interest margin increased to 5.18%, compared to 4.48% for 2001.

As summarized on Table 2, the \$5.8 million increase in net interest income for 2002 consisted of a \$27.2 million decrease in interest expense offset by a \$21.3 million decrease in interest income.

The average yield on earning assets in 2002 decreased by 86 basis points to 7.21% and the average balance of earning assets decreased by \$103.2 million. The \$21.3 million decrease in interest income was primarily due to the \$147.2 million decrease in the average balance of loans.

In 2002, interest costs on interest-bearing deposits and liabilities decreased to \$30.3 million, the average balance of interest-bearing deposits and liabilities decreased by \$146.1 million and the average cost of funds decreased by 161 basis points to 2.15%. The following table sets forth the condensed consolidated average balance sheets, an analysis of interest income/expense and average yield/rate for each major category of earning assets and interest-bearing deposits and liabilities for the years indicated on a taxable equivalent basis. The taxable equivalent adjustment is made for items exempt from federal income taxes (assuming a 35% tax rate) to make them comparable with taxable items before any income

taxes are applied.

Net interest income, on a taxable equivalent basis, was \$71.6 million in 2001, an increase of \$9.8 million, or 15.8%, from 2000. During 2001, the Company's net interest margin increased to 4.48%, compared to 3.91% for 2000. This increase was due to a 93 basis point decrease in the cost of funds, partially offset by a 35 basis point decrease in the yield on average earning assets.

Average earning assets increased \$15.3 million, or 1.0%, in 2001 over 2000. Average interest-bearing deposits and liabilities decreased \$20.8 million, or 1.5%, in 2001 over 2000.

Net interest income, on a taxable equivalent basis, was \$61.8 million in 2000, an increase of \$2.8 million, or 4.7%, from 1999. During 2000, the Company's net interest margin declined to 3.91%, compared to 4.25% for 1999. The \$2.8 million increase in net interest income for 2000 consisted of a \$21.5 million increase in interest income offset by a \$18.8 million increase in interest expense.

**Table of Contents****TABLE 1: DISTRIBUTION OF ASSETS, LIABILITIES AND STOCKHOLDERS EQUITY; INTEREST RATES**

(dollars in thousands)	Average Balance	2002 Interest Income/ Expense	Yield/ Rate	Average Balance	2001 Interest Income/ Expense
<b>ASSETS</b>					
Earning assets:					
Interest-bearing deposits in other banks	\$ 1,052	\$ 25	2.38%	\$ 1,030	\$ 54
Federal funds sold and securities purchased under agreement to resell	11,174	162	1.45	9,871	397
Taxable investment and mortgage/ asset-backed securities	303,433	15,449	5.09	260,867	17,538
Nontaxable investment securities	30,974	2,395	7.73	30,922	2,389
Loans <sup>(1)</sup>	1,149,100	89,752	7.81	1,296,274	108,715
<b>Total earning assets</b>	<b>1,495,733</b>	<b>107,783</b>	<b>7.21</b>	<b>1,598,964</b>	<b>129,093</b>
Nonearning assets:					
Cash and due from banks	35,083			28,835	
Premises and equipment	17,226			18,372	
Other assets	50,528			51,004	
Less allowance for credit losses	(24,174)			(18,496)	
<b>Total assets</b>	<b>\$ 1,574,396</b>			<b>\$ 1,678,679</b>	
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>					
Interest-bearing liabilities:					
Savings deposits	\$ 471,314	\$ 5,255	1.11%	\$ 412,331	\$ 8,927
Time deposits	504,685	12,843	2.54	651,344	30,511
Short-term borrowings	23,339	672	2.88	97,428	5,095
Long-term debt	250,658	11,522	4.60	235,028	12,915
<b>Total interest-bearing deposits and liabilities</b>	<b>1,249,996</b>	<b>30,292</b>	<b>2.42</b>	<b>1,396,131</b>	<b>57,448</b>
Noninterest-bearing liabilities:					
Demand deposits	157,170			130,083	
Other liabilities	22,977			23,799	
<b>Total liabilities</b>	<b>1,430,143</b>			<b>1,550,013</b>	
Stockholders equity	144,253			128,666	
<b>Total liabilities and stockholders equity</b>	<b>\$ 1,574,396</b>			<b>\$ 1,678,679</b>	
Net interest income and margin on total earning assets					
Taxable equivalent adjustment		77,491	5.18%		71,645
		(838)			(839)
<b>Net interest income</b>		<b>\$ 76,653</b>			<b>\$ 70,806</b>



[Continued from above table, first column(s) repeated]

(dollars in thousands)	Yield/ Rate	Average Balance	2000 Interest Income/ Expense	Yield/ Rate
<b>ASSETS</b>				
Earning assets:				
Interest-bearing deposits in other banks	5.24%	\$ 393	\$ 28	7.12%
Federal funds sold and securities purchased under agreement to resell	4.02	7,959	497	6.24
Taxable investment and mortgage/asset-backed securities	6.72	308,011	21,701	7.05
Nontaxable investment securities	7.73	31,036	2,386	7.69
Loans <sup>(1)</sup>	8.39	1,236,305	108,713	8.79
<b>Total earning assets</b>	<b>8.07</b>	<b>1,583,704</b>	<b>133,325</b>	<b>8.42</b>
Nonearning assets:				
Cash and due from banks		34,826		
Premises and equipment		18,077		
Other assets		48,884		
Less allowance for credit losses		(18,248)		
<b>Total assets</b>		<b>\$ 1,667,243</b>		
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>				
Interest-bearing liabilities:				
Savings deposits	2.17%	\$ 367,793	\$ 10,063	2.74%
Time deposits	4.68	672,234	37,041	5.51
Short-term borrowings	5.23	171,006	11,370	6.65
Long-term debt	5.50	205,877	13,004	6.32
<b>Total interest-bearing deposits and liabilities</b>	<b>4.11</b>	<b>1,416,910</b>	<b>71,478</b>	<b>5.04</b>
Noninterest-bearing liabilities:				
Demand deposits		114,048		
Other liabilities		18,153		
<b>Total liabilities</b>		<b>1,549,111</b>		
<b>Stockholders equity</b>		<b>118,132</b>		
<b>Total liabilities and stockholders equity</b>		<b>\$ 1,667,243</b>		
<b>Net interest income and margin on total earning assets</b>	<b>4.48%</b>		<b>61,847</b>	<b>3.91%</b>
<b>Taxable equivalent adjustment</b>			<b>(853)</b>	
<b>Net interest income</b>			<b>\$ 60,994</b>	

<sup>(1)</sup> **Yields and amounts earned include loan fees. Nonaccrual loans have been included in earning assets for purposes of these computations.**

**Table of Contents****TABLE 2: INTEREST DIFFERENTIAL**

(in thousands)	2002 Compared to 2001 Increase (Decrease) due to change in: (1)			2001 Compared to 2000 Increase (Decrease) due to change in: (1)		
	Volume	Rate	Net Change	Volume	Rate	Net Change
<b>Earning assets:</b>						
Interest-bearing deposits in other banks	\$ 1	\$ (30)	\$ (29)	\$ 45	\$ (19)	\$ 26
Federal funds sold and securities purchased under agreements to resell	52	(287)	(235)	119	(219)	(100)
Taxable investment and mortgage/asset-backed securities	2,862	(4,951)	(2,089)	(3,322)	(841)	(4,163)
Nontaxable investment securities	4	2	6	(9)	12	3
Loans (2)	(12,343)	(6,620)	(18,963)	5,273	(5,271)	2
<b>Total earning assets</b>	<b>(9,424)</b>	<b>(11,886)</b>	<b>(21,310)</b>	<b>2,106</b>	<b>(6,338)</b>	<b>(4,232)</b>
<b>Interest-bearing liabilities:</b>						
Savings deposits	1,277	(4,949)	(3,672)	1,219	(2,355)	(1,136)
Time deposits	(6,870)	(10,798)	(17,668)	(1,151)	(5,379)	(6,530)
Short-term borrowings	(3,874)	(549)	(4,423)	(4,892)	(1,383)	(6,275)
Long-term debt	859	(2,252)	(1,393)	1,841	(1,930)	(89)
<b>Total interest-bearing deposits and liabilities</b>	<b>(8,608)</b>	<b>(18,548)</b>	<b>(27,156)</b>	<b>(2,983)</b>	<b>(11,047)</b>	<b>(14,030)</b>
<b>Increase (decrease) in net interest income (taxable equivalent basis)</b>	<b>\$ (816)</b>	<b>\$ 6,662</b>	<b>\$ 5,846</b>	<b>\$ 5,089</b>	<b>\$ 4,709</b>	<b>\$ 9,798</b>

- (1) The change in interest due to both rate and volume has been allocated to volume and rate changes in proportion to the relationship of the absolute dollar amounts of the change in each.
- (2) Yields and amounts earned include loan fees. Nonaccrual loans have been included in earning assets for purposes of these computations.

**NONINTEREST INCOME**

Noninterest income totaled \$12.8 million, \$2.8 million and \$10.0 million in 2002, 2001 and 2000, respectively. The impairment charge on asset-backed securities decreased to \$1.4 million in 2002 from \$10.6 million in 2001. There was a \$2.4 million increase in service charges and fees in 2002 as a result of the Company's concerted effort to increase fee income related to deposit and credit products. Net realized losses on sales of securities increased to \$1.8 million in 2002 from \$169,000 in 2001. Net gains on sales of loans decreased to \$1.5 million in 2002 from \$2.1 million in 2001.

Total noninterest income decreased from \$10.0 million in 2000 to \$2.8 million in 2001. The decrease was primarily due to the \$10.6 million impairment charge on asset-backed securities in 2001. Net realized gains on sales of loans increased to \$2.1 million in 2001 from \$537,000 in 2000. Net realized losses on sales of securities increased from \$421,000 in 2000 to \$169,000 in 2001. There was a \$1.8 million increase in service charges and fees in 2001 as a result of the Company's concerted effort to increase fee income related to deposit and credit products.

The following table sets forth information by category of noninterest income for the years indicated:

(in thousands)	2002	2001	2000
Service charges on deposits	\$ 4,345	\$ 3,811	\$ 2,900

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Other service charges and fees	<b>6,784</b>	4,897	4,063
Net realized losses on sales of securities	<b>(1,765)</b>	(169)	(421)
Net gains on sales of loans	<b>1,493</b>	2,060	537
Earnings on bank-owned life insurance	<b>1,762</b>	1,359	1,383
Impairment on asset-backed securities	<b>(1,399)</b>	(10,642)	
Other	<b>1,595</b>	1,501	1,562
	<u>          </u>	<u>          </u>	<u>          </u>
Total	<b>\$12,815</b>	\$ 2,817	\$10,024
	<u>          </u>	<u>          </u>	<u>          </u>

**Table of Contents****PROVISION AND ALLOWANCE FOR CREDIT LOSSES**

The following table summarizes changes in the allowance for credit losses for the years indicated:

(dollars in thousands)	2002	2001	2000	1999	1998
Balance at beginning of year	<b>\$ 19,464</b>	\$ 17,447	\$ 17,942	\$ 17,771	\$ 16,365
Charge-offs:					
Commercial and financial	<b>6,901</b>	9,052	3,138	442	533
Real estate mortgage	<b>1,353</b>	2,034	4,378	4,085	5,854
Installment and consumer	<b>5,043</b>	1,342	1,490	896	737
Total charge-offs	<b>13,297</b>	12,428	9,006	5,423	7,124
Recoveries:					
Commercial and financial	<b>924</b>	108	170	94	107
Real estate mortgage	<b>1,175</b>	399	537	314	534
Installment and consumer	<b>1,747</b>	310	265	211	453
Total recoveries	<b>3,846</b>	817	972	619	1,094
Net loans charged-off	<b>9,451</b>	11,611	8,034	4,804	6,030
Provision for credit losses	<b>17,110</b>	13,628	7,539	4,975	7,436
Balance at end of year	<b>\$ 27,123</b>	\$ 19,464	\$ 17,447	\$ 17,942	\$ 17,771
Net charge-offs to average loans outstanding	<b>0.82%</b>	0.90%	0.65%	0.45%	0.57%
Allowance for credit losses to year-end loans	<b>2.34%</b>	1.57%	1.34%	1.56%	1.65%
Allowance for credit losses to year-end nonperforming loans	<b>213.06%</b>	123.24%	115.35%	152.28%	133.95%

The provision for credit losses is based upon periodic evaluations by management as to the adequacy of the allowance for credit losses. In these evaluations, management considers numerous factors including, but not limited to, global, national and local economic conditions, loan portfolio composition, loan loss experience and management's estimate of potential losses. These various analyses lead to a determination of the amount needed in the allowance for credit losses. To the extent the existing allowance is below the amount so determined, a provision is made that will bring the allowance to such amount. Thus, the provision for credit losses may fluctuate and may not be comparable from year to year. Factors affecting the components of the allowance for credit losses and the related provision for credit losses are discussed below.

Provision for credit losses was \$17.1 million, \$13.6 million and \$7.5 million in 2002, 2001 and 2000, respectively. The Company's allowance for credit losses increased to \$27.1 million at December 31, 2002, from \$19.5 million at December 31, 2001 and \$17.4 million at December 31, 2000. The allowance for credit losses as a percentage of total loans was 2.34% at December 31, 2002, compared to 1.57% and 1.34% at December 31, 2001 and 2000, respectively. Allowance for credit losses as a percentage of nonperforming loans increased to 213.06% at December 31, 2002 compared to 123.24% and 115.35% at December 31, 2001 and 2000, respectively. The Hawaii economy was emerging from a decade-long recession when the events of September 11, 2001 occurred, significantly affecting the travel and tourism industry upon which Hawaii is very dependent. With the continued global instability and geopolitical issues in the Middle East and Asia, the Hawaii economy and many businesses are vulnerable to another economic downturn. Management believes that the higher provision for loan losses in 2002 is appropriate given the charge-off level and the continued uncertainty of the local, national and global economies.

Total charge-offs were \$13.3 million in 2002, an increase of \$869,000 over the \$12.4 million in 2001. Installment and consumer charge-offs and recoveries increased by \$3.7 million and \$1.4 million, respectively, in 2002 over 2001. The increases were primarily related to charge-off and recoveries in a certain sector of the dealer and automobile financing market. The Bank entered this market in 1999 and, in early 2002, began to experience higher than anticipated delinquencies and charge-offs from this portfolio and, accordingly, tightened its underwriting standards on such loans. The Bank has ceased new production and has substantially exited this sector of the dealer and automobile financing market. At December 31, 2002, the aggregate balance of these loans totaled \$15.7 million, a decrease of \$1.7 million from the prior year.

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The net investment in loans that are considered to be impaired was \$12.3 million at December 31, 2002, a decrease of \$8.0 million from the \$20.3 million at December 31, 2001. Additional information on impaired loans is presented in Note D of Notes to the Company's Consolidated Financial Statements.

The Company's allowance for credit losses represents management's estimate of probable losses inherent in the loan portfolio. The allowance for credit losses is periodically evaluated for adequacy by management. Factors considered include the Company's loan loss experience, known and inherent risks in the portfolio, known adverse situations that may affect the borrower's ability to repay, regulatory policies, and the estimated value of underlying collateral. The evaluation of the adequacy of the allowance is based on the above factors along with prevailing and anticipated economic conditions that may impact borrowers' ability to repay loans. The determination of the allowance is in part objective and in part a subjective judgment by management given the information it currently has in its possession. Adverse changes in any of these factors or the discovery of new adverse information could result in higher charge-offs and loan loss provisions.

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The Allowance consists of allocated and unallocated allowances. The allocated allowance relate to specific allowances for individual loans, pooled graded loans, and homogeneous loans (consumer loans and residential mortgage loans). The Company has established and adopted a loan grading system in which loans are segregated by risk. Certain graded commercial and commercial real estate loans are analyzed on an individual basis based on performance and collateral. The allocated allowance also include a percentage factor for homogenous pools of loans taking into account the Bank's historical losses as well as the present condition, expected performance of each pool and risks inherent in loan concentrations in certain industries or categories.

To mitigate imprecision in the estimates of expected credit losses, the allocated component of the allowance is supplemented by an unallocated component. The unallocated allowance is more judgmental and takes into consideration the risks inherent in the loan portfolio, estimation errors, and economic trends or uncertainties that are not necessarily captured in determining allocated allowances.

There were no material changes in the allowance methodology in 2002 or cross border credits affecting the allowance calculation.

At December 31, 2002, the allowance for loan losses was \$27.1 million, or 2.34% of total loans, an increase of \$7.2 million over the \$19.5 million, or 1.57% of total loans, at December 31, 2001. The components of the allowance, allocated and unallocated, are shown in the table below. The allocated component increased to \$24.6 million at December 31, 2002 from \$17.4 million at December 31, 2001, while the unallocated increased to \$2.5 million at December 31, 2002 from \$2.1 million at December 31, 2001.

Certain changes in loan concentrations, credit quality, terms, and other factors affecting the allocated allowance for credit losses at December 31, 2002 are noted below:

Commercial and financial loans balances declined by \$3.9 million in 2002 to \$226.0 million from \$229.8 million in 2001. Non-performing commercial and financial loans declined by \$1.8 million in 2002 to \$5.2 million from \$7.0 million in 2001. However, the positive affect of the decline in non-performing loans and loan balances on the allocated allowance was offset by a higher loan loss experience factor (the 2002 loss history in this loan category increased 51.1% over 2001) and inherent losses due to the current economic uncertainty in the Hawaii economy related to the global instability and geopolitical issues in the Middle East and Asia. The aggregate effect of these factors was an increase in the allocated allowance for commercial and financial credits to \$15.3 million, an increase of \$4.0 million over 2001.

Real estate construction loan balances of \$52.5 million were relatively flat compared to the previous year-end. However, due to a higher level of risk associated with this loan category, allowances were increased to \$891,000, an increase of \$404,000 over the \$487,000 in 2001.

Real estate residential loans declined to \$444.2 million in 2002, a decrease of \$144.3 million from the \$588.5 million in 2001. The decrease in outstanding loan balances resulted in a \$512,000 reduction in allocated allowance for real estate residential loans to \$1.8 million in 2002, from \$2.3 million in 2001.

Real estate commercial loan balances increased to \$210.5 million, an increase of \$20.1 million over \$190.3 million in 2001. Non-performing loans in this category increased to \$4.2 million, an increase from the \$2.4 million in 2001. Estimated credit loss factors for real estate commercial loan balance were also increased in 2002 due to higher potential delinquencies and other risk factors in this loan category. The aggregate effect of these factors was an increase in the allocated allowance for real estate commercial credits to \$4.7 million, an increase of \$2.1 million over 2001.

Installment and consumer loan balances remained relatively flat at \$135.4 million. Non-performing loans in this category increased to \$4.2 million, an increase of \$1.8 million over the \$2.4 million in 2001. Net charge-offs of \$3.3 million in 2002 represents an increase of \$2.3 million over 2001. Accordingly, estimated credit loss factors on installment and consumer loans were increased due to the higher losses in this loan category. The aggregate effect of these factors was an increase in the allocated allowance to \$2.0 million, an increase of \$1.1 million over 2001.

The unallocated allowance for credit losses at December 31, 2002 was \$2.5 million an increase over the \$2.1 million in 2001. The unallocated balance reflects risks inherent in the loan portfolio, estimation errors, and economic trends or uncertainties that are not necessarily captured in determining allocated allowances. With the continued global instability since the events of September 11, 2001 and geopolitical issues in the Middle East and Asia, the Hawaii economy and many businesses are vulnerable to another economic downturn. In management's judgment, the allowance for credit losses was adequate to absorb potential losses currently inherent in the loan portfolio at December 31, 2002. However, changes in prevailing economic conditions in the Company's markets or in the financial condition of its customers could alter the level of nonperforming assets and charge-offs in the future and, accordingly, affect the allowance for credit losses.

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The allowance for credit losses has been allocated by the Company's management according to the amount deemed to be reasonably necessary to provide for the possibility of loan losses being incurred within the following categories of loans at December 31 for the years indicated:

(dollars in thousands)	2002		2001		2000		1999		1998	
	Amt.	% <sup>(1)</sup>	Amt.	% <sup>(1)</sup>	Amt.	% <sup>(1)</sup>	Amt.	% <sup>(1)</sup>	Amt.	% <sup>(1)</sup>
Commercial & Financial	<b>\$15,250</b>	<b>21.14%</b>	\$11,208	19.19%	\$10,303	19.40%	\$7,359	19.55%	\$4,539	19.41%
Real estate										
Construction	<b>891</b>	<b>4.92</b>	487	4.41		2.06		1.31		2.59
Real estate										
Residential	<b>1,750</b>	<b>41.57</b>	2,262	49.15	2,634	54.45	4,000	22.29	5,221	54.00
Real estate										
Commercial	<b>4,740</b>	<b>19.70</b>	2,594	15.90	2,121	15.10	3,680	17.12	4,298	15.31
Installment										
& Consumer	<b>1,952</b>	<b>12.67</b>	860	11.35	483	9.00	1,432	7.97	1,264	8.69
Unallocated	<b>2,540</b>	<b>n/a</b>	2,053	n/a	1,906	n/a	1,471	n/a	2,449	n/a
<b>Total</b>	<b>\$27,123</b>	<b>100.00%</b>	\$19,464	100.00%	\$17,447	100.00%	\$17,942	100.00%	\$17,771	100.00%

(1) Represents percentage of loans in each category to total loans.

**NONINTEREST EXPENSE**

The following table sets forth information by category of noninterest expense for the years indicated:

(dollars in thousands)	2002	2001	2000
Salaries and employee benefits	<b>\$24,675</b>	\$23,111	\$20,832
Net occupancy expense	<b>6,367</b>	6,588	7,000
Equipment expense	<b>2,942</b>	3,469	3,070
Legal and professional fees	<b>4,740</b>	4,147	4,043
Advertising and promotion	<b>2,716</b>	2,997	2,436
Stationery and supplies	<b>1,034</b>	1,004	1,002
Provision for other real estate owned losses	<b>500</b>	150	243
Deposit insurance premiums	<b>201</b>	227	512
Other	<b>9,443</b>	8,902	7,541
<b>Total</b>	<b>\$52,618</b>	\$50,595	\$46,679
Efficiency ratio	<b>57.37%</b>	59.33%	64.89%

Noninterest expense increased \$2.0 million, or 4.0%, in 2002, as compared to 2001. The Company's efficiency ratio decreased to 57.37% in 2002, as compared to 59.33% in 2001.

Salaries and employment benefits increased by \$1.6 million, or 6.8%, in 2002, to \$24.7 million, compared to \$23.1 million in 2001. The increase in salaries and employee benefits over 2001 was due to higher incentive-based compensation in 2002.

Net occupancy expense was \$6.4 million in 2002, which compares to \$6.6 million in 2001. The decrease in net occupancy expense in 2002 was primarily attributable to the decreased net expenses of the Company's leased facilities, down-sized branches and renegotiated lease agreements.

Equipment expense decreased by \$527,000, or 15.2%, in 2002, primarily due to a reduction in equipment lease payments.



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Legal and professional fees increased by \$593,000, or 14.3%, in 2002, primarily due to an increase in fees related to litigation and certain loan workouts.

Total noninterest expense increased \$3.9 million, or 8.4%, from 2000 to 2001. The primary reason for the increase in noninterest expense was the \$2.3 million increase in salaries and employment benefits.

### **INCOME TAXES**

Total income tax expense of the Company was \$6.3 million, \$3.3 million and \$5.6 million in 2002, 2001 and 2000, respectively. The corresponding effective income tax rate was 31.7%, 34.6% and 33.2%, respectively. The significant decline in the effective tax rate in 2002 as compared to 2001 was primarily due to the utilization of state investment tax credits. Note L of Notes to the Company's Consolidated Financial Statements presents a reconciliation of the Company's effective and statutory income tax rates.

**Table of Contents****SEGMENTS DISCUSSION**

The Company's business segments are Retail Banking, Wholesale Banking, Treasury and All Others. Retail Banking is made up of retail deposits, mortgage banking and consumer lending activities. Wholesale Banking consists of wholesale deposits, commercial real estate lending, corporate lending and the specialized lending functions of the Bank. The Treasury segment is responsible for managing the Company's investment securities portfolio and borrowing. The All Other segment consists of the administrative support of the Bank, transactions of CB Bancshares, Inc. (the Parent Company), and subsidiaries of the Parent Company and Bank. See Note V of Notes to the Consolidated Financial Statements for financial information on segments.

Retail banking net interest income is made up of interest income from revolving real estate, residential real estate and consumer loans, partially offset by the interest expense on retail deposits. Wholesale banking net interest income is made up of interest income from commercial and industrial, real-estate construction, and commercial real estate loans, partially offset by the interest expense on wholesale deposits. Treasury net interest income is derived from the interest income on investment securities, partially offset by the interest expense on short- and long-term borrowings.

Intersegment net interest income is allocated based on the net funding needs of each segment and applying an interest credit or charge based on an internal cost of capital. Other operating income(expense) is the non-interest income and expense designated to Retail Banking, Wholesale Banking, Treasury, and All Other. Administrative overhead allocates the non-interest income/(expense) from the All Other non-banking function segment to the other three segments, Retail Banking, Wholesale Banking and Treasury.

Assets are composed of cash, investments, loans, and fixed and other assets. Loan balances and any corresponding allowance for credit losses are allocated based on loan product types. Fixed assets are allocated by location and function within the Company.

The Company continues to enhance its segment reporting process methodologies for assigning balance sheet and income statement items to the appropriate operating segment. This process is dynamic and, unlike financial accounting, there is no comprehensive, authoritative guidance for management accounting equivalent to generally accepted accounting principles. The Company defines its segments by product and service type.

Allocated net income for Retail Banking segment increased by \$3.4 million, or 20.5%, in 2002 as compared to 2001. This was primarily due to an increase in net interest income of \$4.0 million, or 9.6%. This increase was due to higher net interest margin in 2002. This was partially offset by an increase in the provision for credit losses of \$502,000, or 16.9%, for 2002 as compared to 2001.

Allocated net loss for Wholesale Banking increased by \$1.3 million, or 45.9%, in 2002 as compared to 2001. This was primarily due to increases in the provision for credit losses of \$3.0 million, or 21.1%, and noninterest expense of \$2.2 million, or 18.7%, and a decrease in net interest income of \$1.6 million, or 5.4%, partially offset by a decrease in intersegment net interest expense of \$5.0 million, or 187.3%.

Allocated net income for Treasury increased by \$5.2 million, or 362.7%. This was primarily a result of a decrease in noninterest expense of \$8.7 million, or 210.3%, partially offset by the decrease of intersegment net interest income of \$4.5 million, or 216.5%, in 2002 compared to 2001.

Allocated net loss for the All Other segment decreased by \$41,000, or 2.8%. This was primarily the result of a decrease in non-interest expense of 7.4%, partially offset by an increase in the administrative overhead expense allocation of 8.2%.

**LOAN PORTFOLIO**

Total loans at December 31, 2002 decreased to \$1,068.7 million, a \$128.6 million, or 10.7%, decrease from the previous year-end. The decrease in total loans was primarily due to a decrease in residential mortgage loans.

The amount of loans outstanding at December 31 for the years indicated are shown in the following table categorized as to types of loans:

(in thousands)	2002	2001	2000	1999	1998
Commercial and financial	\$ 225,971	\$ 229,824	\$ 246,877	\$ 224,660	\$ 191,128
Real estate construction	52,538	52,750	26,237	15,096	25,453
Real estate residential mortgage	444,246	588,525	693,068	621,200	531,623
Real estate commercial mortgage	210,512	190,328	192,194	196,810	150,690
Installment and consumer	135,415	135,901	114,562	91,647	85,562

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<u>\$1,068,682</u>	<u>\$1,197,328</u>	<u>\$1,272,938</u>	<u>\$1,149,413</u>	<u>\$984,456</u>
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**Commercial and financial** Loans outstanding in this category comprise 21.1% of total loans, or \$226.0 million, a decrease of \$3.9 million, or 1.7%, below year-end 2001. Loans in this category are primarily loans to small- and medium-sized businesses and professionals doing business in Hawaii. Cash flow from the borrower's business is typically regarded as the principal source of repayment, although the Bank's underwriting policy and practice generally requires collateral as an additional source of repayment, including real estate, where possible, as well as equipment, receivables and personal assets or guarantees as deemed necessary. Risks of credit losses are greater in this loan category relative to other secured loans, such as commercial and residential mortgages, where, generally, a greater percentage of the loan amount is covered by collateral. Any collateral or guarantees obtained mitigates such risk.

**Real estate construction** Loans in this category comprise 4.9% of total loans, or \$52.5 million, virtually unchanged from year-end 2001. For construction loans, each project is evaluated independently for economic viability, while maximum loan-to-value ratios of 80% are generally required. A construction loan poses higher credit risks than a typical secured loan due to the risk that the project will

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not be completed on time and within budget. Consideration of the ability and reputation of the developer and monitoring of a project during the construction phase are undertaken to mitigate the increased risk in construction lending.

**Real estate residential mortgage** Loans in this category comprise 41.6% of total loans, or \$444.2 million, at December 31, 2002, a decrease of \$144.3 million, or 24.5%, below year-end 2001. The decreasing balances are primarily the result of the low interest rate environment which provides an incentive to borrowers to refinance existing loans at lower rates. Prepayments are expected to continue until interest rates increase to the point that refinance activity is not cost-effective for borrowers. The Bank allows a maximum loan-to-value ratio of 80% for residential mortgage loans, although higher levels are permitted with mortgage insurance. First mortgage loans secured by residential properties typically represent a moderate credit risk and the improved residential real estate market is expected to have a positive effect on