CENTRAL PACIFIC FINANCIAL CORP
Form 10-K
March 01, 2007

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

(Mark One)

ý **Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

For the Fiscal year ended December 31, 2006

or

o **Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

Commission file number: 0-10777

Central Pacific Financial Corp.

(Exact name of registrant as specified in its charter)

Hawaii (State or other jurisdiction of incorporation or organization)	**99-0212597** (I.R.S. Employer Identification No.)
220 South King Street, Honolulu, Hawaii (Address of principal executive offices)	**96813** (Zip Code)

Registrant s telephone number, including area code:
(808) 544-0500

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

Title of each class	**Name of each exchange on which registered**
Common Stock, No Par Value	New York Stock Exchange
Preferred Share Purchase Rights	New York Stock Exchange

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. Yesx Noo

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yeso Nox

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. Yesx Noo

Indicate by check mark if 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 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. x

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. Large Accelerated Filer x Accelerated Filero Non-Accelerated Filer o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).Yeso Nox

As of June 30, 2006, the aggregate market value of the common stock held by non-affiliates of the registrant was approximately $1,110,733,000. As of January 31, 2007, the number of shares of common stock of the registrant outstanding was 30,731,206 shares.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant s proxy statement for the 2007 annual meeting of shareholders are incorporated by reference into Part II of this Annual Report on Form 10-K to the extent stated herein. The proxy statement will be filed within 120 days after the end of the fiscal year covered by this Annual Report on Form 10-K.

PART I

Forward-Looking Statements and Factors that Could Affect Future Results

Certain statements contained in this Annual Report on Form 10-K that are not statements of historical fact constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 (the Act), notwithstanding that such statements are not specifically identified. In addition, certain statements may be contained in our future filings with the U.S. Securities and Exchange Commission (SEC), in press releases, and in oral and written statements made by or with the approval of us that are not statements of historical fact and constitute forward-looking statements within the meaning of the Act. Examples of forward-looking statements include, but are not limited to: (i) projections of revenues, expenses, income or loss, earnings or loss per share, the payment or nonpayment of dividends, capital structure and other financial items; (ii) statements of plans, objectives and expectations of Central Pacific Financial Corp. or its management or Board of Directors, including those relating to products or services; (iii) statements of future economic performance; and (iv) statements of assumptions underlying such statements. Words such as believes , anticipates , expects , intends , targeted , continue , remain , will , should , may expressions are intended to identify forward-looking statements but are not the exclusive means of identifying such statements.

Forward-looking statements involve risks and uncertainties that may cause actual results to differ materially from those in such statements. Factors that could cause actual results to differ from those discussed in the forward-looking statements include, but are not limited to:

- Local, regional, national and international economic conditions and events (including natural disasters) and the impact they may have on us and our customers and our assessment of that impact;
- Changes in the economy affecting real estate values;
- Slowdown in construction activity;
- Changes in the level of non-performing assets and charge-offs;
- Changes in estimates of future reserve requirements based upon the periodic review thereof under relevant regulatory and accounting requirements;
- The effects of and changes in trade and monetary and fiscal policies and laws, including the interest rate policies of the Federal Reserve Board (FRB);
- Inflation, interest rate, securities market and monetary fluctuations;
- Political instability;
- Acts of war or terrorism;
- The timely development and acceptance of new products and services and perceived overall value of these products and services by users;
- Changes in consumer spending, borrowings and savings habits;
- Changes in the financial performance and/or condition of our borrowers;
- Technological changes;
- Acquisitions and integration of acquired businesses;
- The ability to increase market share and control expenses;

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- Changes in the competitive environment among financial holding companies and other financial service providers;

- The effect of changes in laws and regulations (including laws and regulations concerning taxes, banking, securities and insurance) with which we and our subsidiaries must comply;

- The effect of changes in accounting policies and practices, as may be adopted by the regulatory agencies, as well as the Public Company Accounting Oversight Board, the Financial Accounting Standards Board and other accounting standard setters;

- Changes in our organization, compensation and benefit plans;

- The costs and effects of legal and regulatory developments including the resolution of legal proceedings or regulatory or other governmental inquiries and the results of regulatory examinations or reviews;

- Greater than expected costs or difficulties related to the integration of new products and lines of business; and

- Our success at managing the risks involved in the foregoing items.

Forward-looking statements speak only as of the date on which such statements are made. We undertake no obligation to update any forward-looking statement to reflect events or circumstances after the date on which such statement is made, or to reflect the occurrence of unanticipated events.

ITEM 1. BUSINESS

General

Central Pacific Financial Corp. is a Hawaii corporation and a bank holding company registered under the Bank Holding Company Act of 1956, as amended. Our principal business is to serve as a holding company for our bank subsidiary, Central Pacific Bank.

Our company was organized on February 1, 1982 to serve as a holding company for our subsidiary, Central Pacific Bank. Central Pacific Bank was incorporated in its present form in the State of Hawaii on March 16, 1982 in connection with the holding company reorganization, and its predecessor entity was incorporated in the State of Hawaii on January 15, 1954.

On September 15, 2004, we completed a merger with CB Bancshares, Inc. (CBBI). CBBI s subsidiaries, which became our wholly-owned subsidiaries, included City Bank, CB Bancshares banking subsidiary, among others. In February 2005, Central Pacific Bank merged with City Bank, with Central Pacific Bank as the surviving entity.

On August 17, 2005, we completed the acquisition of Hawaii HomeLoans, Inc. (HHL), a residential mortgage loan broker. HHL, now known as Central Pacific HomeLoans, Inc., is a wholly-owned subsidiary of Central Pacific Bank.

We refer to Central Pacific Bank herein as our bank or the bank, and when we say we, our or the Company, we mean the holding company on a consolidated basis with the bank and our other consolidated subsidiaries. When we refer to Central Pacific Financial Corp. or to the holding company, we are referring to the parent company on a standalone basis.

Through our bank, we offer full-service commercial banking, with 38 bank branches and more than 90 ATMs located throughout the State of Hawaii. Our administrative and main offices are located in Honolulu, and we have 31 other branches on the island of Oahu. In addition, we operate three branches on the island of Maui, one branch on the island of Kauai and two branches on the island of Hawaii. We also have four loan production offices serving customers in California and two loan production offices in the

state of Washington. Our bank s deposits are insured by the Federal Deposit Insurance Corporation (FDIC) up to applicable limits. The bank is not a member of the Federal Reserve System.

Central Pacific Bank is a full-service community bank offering a broad range of banking products and services including accepting time and demand deposits and originating loans, including commercial loans, construction loans, commercial and residential mortgage loans and consumer loans. We derive our income primarily from interest and fees on loans and, interest on investment securities and fees received in connection with deposit and other services. Our major operating expenses are the interest paid by our bank on deposits and borrowings, salaries and employee benefits and general operating expenses. Our bank relies on a foundation of locally generated deposits. Our operations, like those of other financial institutions that operate in our markets, are significantly influenced by economic conditions in Hawaii, California and Washington, including the strength of the real estate market, and the fiscal and regulatory policies of the federal and state government and the regulatory authorities that govern financial institutions. For more information about the regulation of our holding company and bank, see Supervision and Regulation.

We are committed to maintaining a premier, relationship-based community bank in Hawaii that serves the needs of small to medium-sized businesses and the owners and employees of those businesses. In addition, we are expanding our loan growth opportunities and providing geographic diversification of our credit risk through our loan production offices in California and Washington. The strategy for serving our target markets is the delivery of a finely focused set of value-added products and services that satisfy the primary needs of our customers, emphasizing superior service and relationships as opposed to transaction volume.

Our Services

We offer a full range of banking services and products to small and medium-sized businesses, professionals and individuals. We provide our customers with an array of commercial and consumer loan products, including commercial real estate and construction loans, residential mortgage loans, commercial loans and lines of credit, and consumer loans and lines of credit.

Through our bank, we concentrate our lending activities in four principal areas:

(1) *Commercial Real Estate Lending.* Loans in this category consist primarily of loans secured by commercial real estate, including, but not limited to, structures and facilities to support activities designated as industrial, warehouse, general office, retail, health care, religious and multi-family dwellings. Our underwriting policy generally requires net cash flow from the property to cover the debt service while maintaining an appropriate amount of reserve. Additionally, liquidation of the collateral is available as a secondary source of repayment.

We have teams of highly experienced officers in Hawaii, California and Washington who specialize in commercial real estate lending and have long-established relationships with major real estate developers.

(2) *Construction Lending*. Construction lending encompasses the financing of residential construction projects, including single-family residential developments, apartment buildings and condominiums, as well as commercial construction projects, such as office buildings, warehouses, and retail complexes. Our underwriting standards for residential construction projects generally require minimum pre-sale contracts, maintenance of appropriate reserves and demonstrated experience with previous development projects. We generally consider projected net cash flows, market feasibility, borrower net worth and experience, as well as collateral value as the primary factors in underwriting commercial construction projects.

As with our commercial real estate lending model, we engage teams of highly experienced officers who specialize and construction lending and who maintain close relationships with major real estate developers in all of our markets.

(3) *Residential Mortgage Lending.* Residential mortgage loans include both fixed and adjustable-rate loans primarily secured by single-family owner-occupied residences. We typically require loan-to-value ratios of not more than 80%, although higher levels are permitted with accompanying mortgage insurance. We emphasize residential mortgage loans for owner-occupied primary residences and do not actively seek loans on high-end residences, vacation homes or investment properties. First mortgage loans secured by residential properties generally carry a moderate level of credit risk. With an average loan size of approximately $199,000, readily marketable collateral and a strong residential real estate market, credit losses on residential mortgages have been minimal during the past several years. However, future changes in interest rates and other market factors can impact the marketability of collateral and thus the level of credit risk inherent in the portfolio.

Through Central Pacific HomeLoans, we have grown our market position in the residential mortgage arena, with dedicated mortgage lending specialists on all major islands in Hawaii.

(4) *Commercial Lending and Leasing.* Loans in this category consist primarily of term loans, lines of credit and equipment leases to small and middle-market businesses and professionals in the State of Hawaii. The borrower s business is typically regarded as the principal source of repayment, although our underwriting policies and practices generally require additional sources of collateral, including real estate and other business assets, as well as personal guarantees where possible to mitigate risk. Risks of credit losses are greater in this loan category relative to secured loans, such as commercial and residential mortgages where a greater percentage of the loan amount is usually covered by collateral. Nonetheless, any collateral or personal guarantees obtained on commercial loans can mitigate the increased risk and help to reduce credit losses.

Our commercial lending and leasing model involves teams of experienced personnel with established networks of business contacts who focus on marketing loans, deposits and other bank services to new and existing commercial clients.

In addition, we offer deposit products and services including checking, savings and time deposits, cash management and internet banking services, trust services and retail brokerage services.

Our Market Area and Competition

Based on deposit market share among FDIC-insured financial institutions in Hawaii, Central Pacific Bank was the fourth-largest depository institution in the State of Hawaii at December 31, 2006, with $3.8 billion in deposits, representing a 15% market share.

The banking and financial services industry in the State of Hawaii generally, and in our target market areas, is highly competitive. We compete for loans, deposits and customers with other commercial banks, savings and loan associations, securities and brokerage companies, mortgage companies, insurance companies, finance companies, credit unions and other nonbank financial service providers. Many of these competitors are much larger in total assets and capitalization and have greater access to capital markets.

In order to compete with the other financial services providers in the State of Hawaii, we principally rely upon local promotional activities, personal relationships between customers and our officers, directors and employees, and specialized services tailored to meet the needs of our customers and the communities we serve. We remain competitive by offering flexibility and superior service levels, coupled with competitive interest rates and pricing.

Our loan production offices in California and Washington likewise face strong competition in the commercial real estate lending sector. Competitors range from large national banks to regional and community banks. Nonbanks, including brokerage firms, conduits and insurance companies, also compete for commercial real estate lending business. Some of these competitors compete by pricing aggressively and by lowering their underwriting standards. To mitigate these competitive pressures and credit risks, we rely upon our teams of experienced commercial real estate lenders and a lending approach which targets clients with solid track records, substantial net worth and adequate liquidity.

Business Concentrations

No individual or single group of related accounts is considered material in relation to the assets or deposits of our bank, or in relation to the overall business of the Company. However, approximately 83% of our loan portfolio held for investment at December 31, 2006 consisted of real estate-related loans, including construction loans, residential mortgage loans and commercial mortgage loans. See Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations Financial Condition Loan Portfolio. Our business activities are currently focused primarily in Hawaii, California and Washington, with the majority of our deposit growth generated in Hawaii and the majority of loan growth achieved in 2006 originating in California. Consequently, our results of operations and financial condition are affected by the general economic trends in Hawaii and California, and to a lesser extent in Washington, particularly in the commercial and residential real estate markets.

Our Subsidiaries

Central Pacific Bank is the principal wholly-owned subsidiary of Central Pacific Financial Corp. Other wholly-owned subsidiaries include: Datatronix Financial Services, Inc., an item processing company that ceased operations in 2006; CPB Capital Trust I; CPB Capital Trust II; CPB Statutory Trust III; CPB Capital Trust IV; CPB Statutory Trust V; CB Technology, Inc.; CPB Real Estate, Inc.; Citibank Properties, Inc.; CB Technology, Inc. and Central Pacific HomeLoans, Inc.

Central Pacific Bank or its wholly-owned subsidiary, Central Pacific HomeLoans, Inc., also owns 50% of the following Hawaii limited liability corporations: Pacific Access Mortgage, LLC; Lokahi Mortgage, LLC; Gentry HomeLoans, LLC; Towne Island Mortgage, LLC; Pacific Island HomeLoans, LLC and Hawaii Resort Lending, LLC.

Supervision and Regulation

Set forth below is a description of the significant elements of the laws and regulations applicable to us and Central Pacific Bank. The description is qualified in its entirety by reference to the full text of the statutes, regulations and policies that are described. Also, such statutes, regulations and policies are continually under review by Congress and state legislatures and federal and state regulatory agencies. A change in statutes, regulations or regulatory policies applicable to us and Central Pacific Bank could have a material effect on our business.

Regulatory Agencies

Central Pacific Financial Corp. is a legal entity separate and distinct from its subsidiaries. As a bank holding company, Central Pacific Financial Corp. is regulated under the Bank Holding Company Act of 1956, as amended (BHC Act), and is subject to inspection, examination and supervision by the Board of Governors of the Federal Reserve System.

The Company is also under the jurisdiction of the Securities and Exchange Commission and is subject to the disclosure and regulatory requirements of the Securities Act of 1933, as amended, and the Securities Exchange Act of 1934, as amended, as administered by the SEC. Our common stock is listed on the New

York Stock Exchange (NYSE) under the trading symbol CPF, and we are subject to the rules of the NYSE for companies listed there.

Central Pacific Bank, as a Hawaii-chartered bank, is subject to primary supervision, periodic examination, and regulation by the State of Hawaii Division of Financial Institutions (DFI) and the FDIC. The bank is also subject to certain regulations promulgated by the FRB. If, as a result of an examination of the bank, the FDIC should determine that the financial condition, capital resources, asset quality, earnings prospects, management, liquidity, or other aspects of its operations are unsatisfactory or that it or its management is violating or has violated any law or regulation, various remedies are available to the FDIC. Such remedies include the power to enjoin unsafe or unsound practices, to require affirmative action to correct any conditions resulting from any violation or practice, to issue an administrative order that can be judicially enforced, to direct an increase in capital, to restrict its growth, to assess civil monetary penalties, to remove officers and directors, and ultimately to terminate its deposit insurance, which for a Hawaii-chartered bank would result in a revocation of its charter. The DFI separately enjoys many of the same remedial powers.

Bank Holding Company Activities

In general, the BHC Act limits the business of bank holding companies to banking, managing or controlling banks and other activities that the FRB has determined to be so closely related to banking as to be a proper incident thereto. As a result of the Gramm-Leach-Bliley Act of 1999, which amended the BHC Act, bank holding companies that are financial holding companies may engage in any activity, or acquire and retain the shares of a company engaged in any activity that is either (i) financial in nature or incidental to such financial activity or (ii) complementary to a financial activity and that does not pose a substantial risk to the safety and soundness of depository institutions or the financial system generally (as solely determined by the FRB). Activities that are financial in nature include securities underwriting and dealing, insurance underwriting and making merchant banking investments.

If a bank holding company seeks to engage in the broader range of activities that are permitted under the BHC Act for financial holding companies, (i) all of its depository institution subsidiaries must be well capitalized and well managed and (ii) it must file a declaration with the FRB that it elects to be a financial holding company. A depository institution subsidiary is considered to be well capitalized if it satisfies the requirements for this status discussed in the section captioned Capital Adequacy and Prompt Corrective Action, included elsewhere in this item. A depository institution subsidiary is considered well managed if it received a composite rating and management rating of at least satisfactory in its most recent examination.

In order for a financial holding company to commence any new activity permitted by the BHC Act, or to acquire a company engaged in any new activity permitted by the BHC Act, each insured depository institution subsidiary of the financial holding company must have received a rating of at least satisfactory in its most recent examination under the Community Reinvestment Act. See the section captioned Community Reinvestment Act included elsewhere in this item.

The BHC Act generally limits acquisitions by bank holding companies that are not qualified as financial holding companies to commercial banks and companies engaged in activities that the FRB has determined to be so closely related to banking as to be a proper incident thereto. Financial holding companies are also permitted to acquire companies engaged in activities that are financial in nature and in activities that are incidental and complementary to financial activities without prior FRB approval. Central Pacific has not filed a declaration electing Financial Holding Company status and has no current intention to do so.

The BHC Act, the Federal Bank Merger Act, Hawaii law and other federal and state statutes regulate acquisitions of commercial banks. The BHC Act requires the prior approval of the FRB for the direct or indirect acquisition of more than 5.0% of the voting shares of a commercial bank or its parent holding company. In reviewing applications seeking approval of merger and acquisition transactions, the bank regulatory authorities will consider, among other things, the competitive effect and public benefits of the transactions, the capital position of the combined organization, the applicant s performance record under the Community Reinvestment Act (see the section captioned Community Reinvestment Act included elsewhere in this item) and fair housing laws and the effectiveness of the subject organizations in combating money laundering activities.

Dividends

The principal source of Central Pacific Financial Corp. s cash revenues is from dividends from its subsidiary bank. The ability of our subsidiary bank to pay dividends or make other capital distributions to us is subject to the Hawaii state law that prohibits a state-chartered bank from declaring or paying dividends greater than its retained earnings. As of December 31, 2006, Central Pacific Bank s retained earnings totaled $278.6 million. In addition, federal law generally prohibits a depository institution from making any capital distributions (including payment of a dividend) or paying any management fee to its parent holding company if the depository institution would thereafter be undercapitalized. As of December 31, 2006, the total risk-based capital maintained by Central Pacific Bank in excess of minimum capital requirements was $223.6 million.

Affiliate Transactions

There are various restrictions on the ability of the holding company and its non-bank subsidiaries to borrow from, and engage in certain other transactions with, our subsidiary bank. In general, these restrictions require that any extensions of credit must be secured by designated amounts of specified collateral and are limited, as to any one of the holding company or its non-bank subsidiaries, to 10% of our subsidiary bank s capital stock and surplus, and, as to the holding company and all such non-bank subsidiaries in the aggregate, to 20% of our subsidiary bank s capital stock and surplus.

Federal law also provides that extensions of credit and other transactions between our subsidiary bank and the holding company or one of its non-bank subsidiaries must be on terms and conditions, including credit standards, that are substantially the same or at least as favorable to our subsidiary bank as those prevailing at the time for comparable transactions involving other non-affiliated companies or, in the absence of comparable transactions, on terms and conditions, including credit standards, that in good faith would be offered to, or would apply to, non-affiliated companies.

Source of Strength Doctrine

FRB policy requires bank holding companies to act as a source of financial and managerial strength to their subsidiary banks. Under this policy, we are expected to commit resources to support our subsidiary bank, including at times when we may not be in a financial position to provide it. Any capital loan by a bank holding company to any of its subsidiary banks is subordinate in right of payment to deposits and to certain other indebtedness of such subsidiary banks. The BHC Act provides that, in the event of a bank holding company s bankruptcy, any commitment by the bank holding company to a federal bank regulatory agency to maintain the capital of a subsidiary bank will be assumed by the bankruptcy trustee and entitled to priority of payment.

Capital Adequacy and Prompt Corrective Action

Banks and bank holding companies are subject to various regulatory capital requirements administered by state and federal banking agencies. Capital adequacy guidelines and, additionally for banks, prompt corrective action regulations, involve quantitative measures of assets, liabilities, and certain off-balance-sheet items calculated under regulatory accounting practices. Capital amounts and classifications are also subject to qualitative judgments by regulators about components, risk weighting and other factors.

The FDIC and the DFI have substantially similar risk-based capital ratio and leverage ratio guidelines for banking organizations. The guidelines are intended to ensure that banking organizations have adequate capital given the risk levels of assets and off-balance sheet financial instruments. Under the guidelines, banking organizations are required to maintain minimum ratios for Tier 1 capital and total capital to risk-weighted assets (including certain off-balance sheet items, such as letters of credit). For purposes of calculating the ratios, a banking organization s assets and some of its specified off-balance sheet commitments and obligations are assigned to various risk categories. A depository institution s or holding company s capital, in turn, is classified in one of three tiers, depending on type:

- *Core Capital (Tier 1).* Tier 1 capital includes common equity, retained earnings, qualifying non-cumulative perpetual preferred stock, a limited amount of qualifying cumulative perpetual stock at the holding company level, minority interests in equity accounts of consolidated subsidiaries, less goodwill, most intangible assets and certain other assets.

- *Supplementary Capital (Tier 2).* Tier 2 capital includes, among other things, perpetual preferred stock not meeting the Tier 1 definition, qualifying mandatory convertible debt securities, qualifying subordinated debt, and allowances for possible loan losses, subject to limitations.

- *Market Risk Capital (Tier 3).* Tier 3 capital includes qualifying unsecured subordinated debt.

We, like other bank holding companies, are required to maintain Tier 1 capital and total capital (the sum of Tier 1, Tier 2 and Tier 3 capital) equal to at least 4.0% and 8.0%, respectively, of total risk-weighted assets (including various off-balance-sheet items, such as standby letters of credit). Our subsidiary bank, like other depository institutions, is required to maintain similar capital levels under capital adequacy guidelines. For a depository institution to be considered well capitalized under the regulatory framework for prompt corrective action it s Tier 1 and total capital ratios must be at least 6.0% and 10.0% on a risk-adjusted basis, respectively.

Bank holding companies and banks subject to the market risk capital guidelines are required to incorporate market and interest rate risk components into their risk-based capital standards. Under the market risk capital guidelines, capital is allocated to support the amount of market risk related to a financial institution s ongoing trading activities.

Bank holding companies and banks are also required to comply with minimum leverage ratio requirements. The leverage ratio is the ratio of a banking organization s Tier 1 capital to its total adjusted quarterly average assets (as defined for regulatory purposes). The requirements necessitate a minimum leverage ratio of 3.0% for financial holding companies and national banks that either have the highest supervisory rating or have implemented the appropriate federal regulatory authority s risk-adjusted measure for market risk. All other financial holding companies and banks are required to maintain a minimum leverage ratio of 4.0%, unless a different minimum is specified by an appropriate regulatory authority. For a depository institution to be considered well capitalized under the regulatory framework for prompt corrective action, its leverage ratio must be at least 5.0%. The FRB has not advised Central Pacific of any specific minimum leverage ratio applicable to it.

The Federal Deposit Insurance Act, as amended (FDIA), requires among other things, the federal banking agencies to take prompt corrective action in respect of depository institutions that do not meet minimum capital requirements. The FDIA sets forth the following five capital tiers: well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized and critically undercapitalized. A depository institut capital tier will depend upon how its capital levels compare with various relevant capital measures and certain other factors, as established by regulation. The relevant capital measures are the total capital ratio, the Tier 1 capital ratio and the leverage ratio.

Under the regulations adopted by the federal regulatory authorities, a bank will be: (i) well capitalized if the institution has a total risk-based capital ratio of 10.0% or greater, a Tier 1 risk-based capital ratio of 6.0% or greater, and a leverage ratio of 5.0% or greater, and is not subject to any order or written directive by any such regulatory authority to meet and maintain a specific capital level for any capital measure;
(ii) adequately capitalized if the institution has a total risk-based capital ratio of 8.0% or greater, a Tier 1 risk-based capital ratio of 4.0% or greater, and a leverage ratio of 4.0% or greater (3.0% in certain circumstances) and is not well capitalized ; (iii) undercapitalized if the institution has a total risk-based capital ratio that is less than 8.0%, a Tier 1 risk-based capital ratio of less than 4.0% or a leverage ratio of less than 4.0% (3.0% in certain circumstances); (iv) significantly undercapitalized if the institution has a total risk-based capital ratio of less than 6.0%, a Tier 1 risk-based capital ratio of less than 3.0% or a leverage ratio of less than 3.0%; and (v) critically undercapitalized if the institution s tangible equity is equal to or less than 2.0% of average quarterly tangible assets. An institution may be downgraded to, or deemed to be in, a capital category that is lower than indicated by its capital ratios if it is determined to be in an unsafe or unsound condition or if it receives an unsatisfactory examination rating with respect to certain matters. A bank s capital category is determined solely for the purpose of applying prompt corrective action regulations, and the capital category may not constitute an accurate representation of the bank s overall financial condition or prospects for other purposes.

The FDIA generally prohibits a depository institution from making any capital distributions (including payment of a dividend) or paying any management fee to its parent holding company if the depository institution would thereafter be undercapitalized. Undercapitalized institutions are subject to growth limitations and are required to submit a capital restoration plan. The agencies may not accept such a plan without determining, among other things, that the plan is based on realistic assumptions and is likely to succeed in restoring the depository institution s capital. In addition, for a capital restoration plan to be acceptable, the depository institution s parent holding company must guarantee that the institution will comply with such capital restoration plan. The aggregate liability of the parent holding company is limited to the lesser of (i) an amount equal to 5.0% of the depository institution s total assets at the time it became undercapitalized and (ii) the amount which is necessary (or would have been necessary) to bring the institution into compliance with all capital standards applicable with respect to such institution as of the time it fails to comply with the plan. If a depository institution fails to submit an acceptable plan, it is treated as if it is significantly undercapitalized.

Significantly undercapitalized depository institutions may be subject to a number of requirements and restrictions, including orders to sell sufficient voting stock to become adequately capitalized, requirements to reduce total assets, and cessation of receipt of deposits from correspondent banks. Critically undercapitalized institutions are subject to the appointment of a receiver or conservator.

As of December 31, 2006, our capital ratios and the capital ratios of Central Pacific Bank exceeded the minimum thresholds for a well-capitalized institution. The following table sets forth actual and required capital ratios as of December 31, 2006 and 2005:

	Actual		Minimum required for capital adequacy purposes		Minimum required to be well-capitalized	
	Amount (Dollars in thousands)	Ratio	Amount	Ratio	Amount	Ratio
Company						
As of December 31, 2006:						
Tier 1 risk-based capital	$ 553,254	12.3 %	$ 179,292	4.0 %	$ 268,939	6.0 %
Total risk-based capital	608,192	13.6	358,585	8.0	448,231	10.0
Leverage capital	553,254	10.9	202,538	4.0	253,173	5.0
As of December 31, 2005:						
Tier 1 risk-based capital	$ 477,828	10.7 %	$ 178,984	4.0 %	$ 268,477	6.0 %
Total risk-based capital	533,771	11.9	357,969	8.0	447,461	10.0
Leverage capital	477,828	10.0	191,058	4.0	238,822	5.0
Central Pacific Bank						
As of December 31, 2006:						
Tier 1 risk-based capital	$ 526,228	11.8 %	$ 178,769	4.0 %	$ 268,154	6.0 %
Total risk-based capital	581,166	13.0	357,538	8.0	446,923	10.0
Leverage capital	526,228	10.4	203,325	4.0	254,157	5.0
As of December 31, 2005:						
Tier 1 risk-based capital	$ 437,844	9.8 %	$ 178,675	4.0 %	$ 268,012	6.0 %
Total risk-based capital	493,691	11.1	357,350	8.0	446,687	10.0
Leverage capital	437,844	9.3	189,280	4.0	236,601	5.0

The federal regulatory authorities risk-based capital guidelines are based upon the 1988 capital accord of the Basel Committee on Banking Supervision, or the BIS. The BIS is a committee of central banks and bank supervisors/regulators from the major industrialized countries that develops broad policy guidelines for use by each country s supervisors in determining the supervisory policies they apply. In 2004, the BIS published a new capital accord to replace its 1988 capital accord, with an update in November 2005 (BIS II). BIS II provides two approaches for setting capital standards for credit risk an internal ratings-based approach tailored to individual institutions circumstances (which for many asset classes is itself broken into a foundation approach and an advanced or A-IRB approach, the availability of which is subject to additional restrictions) and a standardized approach that bases risk weightings on external credit assessments to a much greater extent than permitted in existing risk-based capital guidelines. BIS II also would set capital requirements for operational risk and refine the existing capital requirements for market risk exposures.

The U.S. banking and thrift agencies are developing proposed revisions to their existing capital adequacy regulations and standards based on BIS II. In September 2006, the agencies issued a notice of proposed rulemaking setting forth a definitive proposal for implementing BIS II in the United States that would apply only to internationally active banking organizations defined as those with consolidated total assets of $250 billion or more or consolidated on-balance sheet foreign exposures of $10 billion or more but that other U.S. banking organizations could elect but would not be required to apply. In December 2006, the agencies issued a notice of proposed rulemaking describing proposed amendments to their existing risk-based capital guidelines to make them more risk-sensitive, generally following aspects of the standardized approach of BIS II. These latter proposed amendments, often referred to as BIS I-A , would apply to banking organizations that are not internationally active banking organizations subject to the A-IRB approach for internationally active banking organizations and do not opt in to that approach.

The comment periods for both of the agencies notices of proposed rulemakings expire on March 26, 2007. The agencies have indicated their intent to have the new requirements first become effective in 2009 and that those provisions and the BIS I-A provisions for others will be implemented on similar timeframes.

The Company is not an internationally active banking organization and does not expect to opt-in to the A-IRB provisions once they become effective.

Deposit Insurance

Substantially all of the deposits of our bank subsidiary are insured up to applicable limits by the Deposit Insurance Fund (DIF) of the FDIC and are subject to deposit insurance assessments to maintain the DIF. Our bank subsidiary paid no insurance assessments on these deposits during the most recent semi-annual period. However, in November 2006, the FDIC issued a final rule to be effective January 1, 2007 that creates a new assessment system designed to more closely tie what banks pay for deposit insurance to the risks they pose and adopts a new base schedule of rates that the FDIC can adjust up or down, depending on the revenue needs of the insurance fund. This new assessment system is expected to result in increased annual assessments on deposits of our bank subsidiary of 5 to 7 cents for each $100 of domestically held deposits. An FDIC credit for prior contributions is expected to offset the assessment for 2007 and may offset a portion of the assessment for 2008. Significant increases in the insurance assessments our bank subsidiary pays will increase our costs once the credit is utilized or otherwise disposed of.

Depositor Preference

The FDIA provides that, in the event of the liquidation or other resolution of an insured depository institution, the claims of depositors of the institution, including the claims of the FDIC as subrogee of insured depositors, and certain claims for administrative expenses of the FDIC as a receiver, will have priority over other general unsecured claims against the institution. If an insured depository institution fails, insured and uninsured depositors, along with the FDIC, will have priority in payment ahead of unsecured, non-deposit creditors, including the parent bank holding company, with respect to any extensions of credit they have made to such insured depository institution.

Community Reinvestment Act

The Community Reinvestment Act of 1977, or the CRA, requires depository institutions to assist in meeting the credit needs of their market areas consistent with safe and sound banking practice. Under the CRA, each depository institution is required to help meet the credit needs of its market areas by, among other things, providing credit to low- and moderate-income individuals and communities. Depository institutions are periodically examined for compliance with the CRA and are assigned ratings. In order for a financial holding company to commence any new activity permitted by the BHC Act, or to acquire any company engaged in any new activity permitted by the BHC Act, each insured depository institution subsidiary of the financial holding company must have received a rating of at least satisfactory in its most recent examination under the CRA. Furthermore, banking regulators take into account CRA ratings when considering approval of a proposed transaction.

Financial Privacy

In accordance with the GLB Act, federal banking regulators adopted rules that limit the ability of banks and other financial institutions to disclose non-public information about consumers to nonaffiliated third parties. These limitations require disclosure of privacy policies to consumers and, in some circumstances, allow consumers to prevent disclosure of certain personal information to a nonaffiliated third party. The privacy provisions of the GLB Act affect how consumer information is transmitted through diversified financial companies and conveyed to outside vendors.

Anti-Money Laundering Initiatives and the USA Patriot Act

A major focus of governmental policy on financial institutions in recent years has been aimed at combating money laundering and terrorist financing. The USA PATRIOT Act of 2001, or the USA Patriot Act, substantially broadened the scope of United States anti-money laundering laws and regulations by imposing significant new compliance and due diligence obligations, creating new crimes and penalties and expanding the extra-territorial jurisdiction of the United States. The United States Treasury Department has issued a number of regulations that apply various requirements of the USA Patriot Act to financial institutions such as our bank and broker-dealer subsidiaries. These regulations impose obligations on financial institutions to maintain appropriate policies, procedures and controls to detect, prevent and report money laundering and terrorist financing and to verify the identity of their customers. Failure of a financial institution to maintain and implement adequate programs to combat money laundering and terrorist financing, or to comply with all of the relevant laws or regulations, could have serious legal and reputational consequences for the institution.

In December 2006, Central Pacific Bank agreed to a cease and desist order (the Order) with the FDIC and DFI. The Order requires the bank to take additional steps to improve our program for detecting, monitoring and reporting large currency transactions and suspicious activity as mandated by the Bank Secrecy Act (BSA). BSA regulations, an integral component of the government s anti-money laundering initiatives, require banks to detect, monitor and report currency transactions of $10,000 or more and other suspicious activity. The Order, which arose from an annual examination by the FDIC and DFI, requires the bank to take certain specific steps to bring it into compliance in all material respects with the BSA. To date, the bank has implemented numerous improvements that address the requirements of the Order, such as increasing oversight, supervision and staffing of BSA compliance; improving its practices and procedures to monitor and report transactions; and conducting training, as well as providing for auditing and independent testing of bank practices to ensure adherence to tighter BSA standards. The bank is currently implementing new software programs that will monitor transactions as required by these BSA standards. We expect to fully comply with the Order by mid-year 2007 and will seek to have the Order rescinded soon thereafter.

Office of Foreign Assets Control Regulation

The United States has imposed economic sanctions that affect transactions with designated foreign countries, nationals and others. These are typically known as the OFAC rules based on their administration by the U.S. Treasury Department Office of Foreign Assets Control (OFAC). The OFAC-administered sanctions targeting countries take many different forms. Generally, however, they contain one or more of the following elements: (i) restrictions on trade with or investment in a sanctioned country, including prohibitions against direct or indirect imports from and exports to a sanctioned country and prohibitions on U.S. persons engaging in financial transactions relating to making investments in, or providing investment-related advice or assistance to, a sanctioned country; and (ii) a blocking of assets in which the government or specially designated nationals of the sanctioned country have an interest, by prohibiting transfers of property subject to U.S. jurisdiction (including property in the possession or control of U.S. persons). Blocked assets (e.g., property and bank deposits) cannot be paid out, withdrawn, set off or transferred in any manner without a license from OFAC. Failure to comply with these sanctions could have serious legal and reputational consequences.

Legislative Initiatives

From time to time, various legislative and regulatory initiatives are introduced in Congress and state legislatures, as well as by regulatory agencies. Such initiatives may include proposals to expand or contract the powers of bank holding companies and depository institutions or proposals to substantially change the financial institution regulatory system. Such legislation could change banking statutes and our operating environment in substantial and unpredictable ways. If enacted, such legislation could increase or decrease the cost of doing business, limit or expand permissible activities or affect the competitive balance among banks, savings associations, credit unions, and other financial institutions. We cannot predict whether any such legislation will be enacted, and, if enacted, the effect that it, or any implementing regulations, would have on our financial condition or results of operations. A change in statutes, regulations or regulatory policies applicable to us or any of our subsidiaries could have a material effect on our business.

Employees

At January 31, 2007, we employed 1,008 persons, 944 on a full-time basis and 64 on a part-time basis. We are not a party to any collective bargaining agreement.

Available Information

Our internet website can be found at www.centralpacificbank.com. Our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and all amendments to those reports can be found on our internet website as soon as reasonably practicable after such material is electronically filed with or furnished to the SEC. Copies of the Company s filings with the SEC may also be obtained directly from the SEC s website at www.sec.gov. These documents may also be obtained in print upon request by our shareholders to our Investor Relations Department.

Also posted on our website, and available in print upon request of any shareholder to our Investor Relations Department, are the charters for our Audit Committee, our Compensation Committee and our Corporate Governance and Nominating Committee, as well as our Corporate Governance Guidelines and our Code of Business Conduct and Ethics. Within the time period required by the SEC and the NYSE, we will post on our website any amendment to the Code of Business Conduct and Ethics and any waiver applicable to our senior financial officers, as defined by the SEC, and our executive officers or directors. In addition, our website includes information concerning purchases and sales of our equity securities by our executive officers and directors, as well as disclosure relating to certain non-GAAP financial measures (as defined in the SEC s Regulation G) that we may make public orally, telephonically, by webcast, by broadcast or by similar means from time to time.

ITEM 1A. RISK FACTORS

An investment in our common stock is subject to risks inherent to our business. The material risks and uncertainties that management believes affect us are described below. Before making an investment decision, you should consider carefully the risks and uncertainties described below together with all of the other information included or incorporated by reference in this report. The risks and uncertainties described below are not the only ones we face. Additional risks and uncertainties that management is not aware of or focused on or that management currently deems immaterial may also impair our business operations. This report is qualified in its entirety by these risk factors.

If any of the following risks actually occurs, our financial condition and results of operations could be materially and adversely affected. If this were to happen, the value of our common stock could decline significantly, and you could lose all or part of your investment.

Factors That May Affect Our Business

The risks and uncertainties described below are not the only ones we face. Additional risks and uncertainties that we are unaware of, or that we currently deem immaterial, also may become important factors that affect us. If any one or a combination of these risks occurs, our business, financial condition or results of operations could be materially and adversely affected.

Changes in economic conditions, in particular an economic slowdown in Hawaii, California or Washington, could materially hurt our business.

Our business is directly affected by factors such as economic, political and market conditions, broad trends in industry and finance, legislative and regulatory changes, changes in government monetary and fiscal policies and inflation, all of which are beyond our control. Deterioration in economic conditions, in particular an economic slowdown in Hawaii, California or Washington, could result in the following consequences, any of which could materially hurt our business:

- loan delinquencies may increase;
- problem assets and foreclosures may increase;
- demand for our products and services may decline;
- low cost or non-interest bearing deposits may decrease; and
- collateral for loans made by us, especially involving real estate, may decline in value, in turn reducing customers borrowing power, and reducing the value of assets and collateral associated with our existing loans.

A large percentage of our loans are collateralized by real estate, and an adverse change in the real estate market may result in losses and adversely affect our profitability.

Approximately 83% of our loan portfolio as of December 31, 2006 was comprised of loans collateralized by real estate. An adverse change in the economy affecting real estate values generally or in our primary markets specifically could significantly impair the value of our collateral and our ability to sell the collateral upon foreclosure. In the event of a default with respect to any of these loans, amounts received upon sale of the collateral may be insufficient to recover outstanding principal and interest on the loan. As a result, our profitability could be negatively impacted by an adverse change in the real estate market.

A large percentage of our real estate loans are construction loans which involve the additional risk that a project may not be completed, increasing the risk of loss.

Approximately 36% of our real estate loan portfolio as of December 31, 2006 was comprised of construction loans. Repayment of construction loans is often dependent upon the successful completion of the construction project, on time and within budget. If a borrower is unable to complete a construction project, or if the marketability of the completed development is impaired, proceeds from the sale of the subject property may be insufficient to repay the loan. As a result, we may incur loan losses, adversely affecting our profitability.

Our business is subject to interest rate risk, and fluctuations in interest rates may adversely affect our earnings.

The majority of our assets and liabilities are monetary in nature and subject to risk from changes in interest rates. Like most financial institutions, our earnings and profitability depend significantly on our net interest income, which is the difference between interest income on interest-earning assets, such as loans and investment securities, and interest expense on interest-bearing liabilities, such as deposits and borrowings. We expect that we will periodically experience gaps in the interest rate sensitivities of our assets and liabilities, meaning that either our interest-bearing liabilities will be more sensitive to changes in market interest rates than our interest-earning assets, or vice versa. If market interest rates should move contrary to our position, this gap will work against us, and our earnings may be negatively affected. In light of our current volume and mix of interest-earning assets and interest-bearing liabilities, our interest rate spread could be expected to increase during periods of rising interest rates and, conversely, to decline during periods of falling interest rates. We are unable to predict or control fluctuations of market interest rates, which are affected by many factors, including the following:

- inflation;
- recession;
- changes in unemployment;
- the money supply; and
- international disorder and instability in domestic and foreign financial markets.

Our asset/liability management strategy may not be able to control our risk from changes in market interest rates, and it may not be able to prevent changes in interest rates from having a material adverse effect on our results of operations and financial condition.

In the fourth quarter of 2006, we repositioned our investment portfolio to reduce our net interest income volatility, as well as increasing our prospective earnings and net interest margin. As a result of the repositioning, we believe that we have reduced our interest rate risk exposure to declining market interest rates and expect a positive impact on 2007 net interest inocme and net interest margin.

Our allowance for loan losses may not be sufficient to cover actual loan losses, which could adversely affect our results of operations.

As a lender, we are exposed to the risk that our loan customers may not repay their loans according to their terms and that the collateral or guarantees securing these loans may be insufficient to assure repayment. We may experience significant loan losses that could have a material adverse effect on our operating results. Management makes various assumptions and judgments about the collectibility of our loan portfolio, which are based, in part, on:

- current economic conditions and their estimated effects on specific borrowers;
- an evaluation of the existing relationships among loans, potential loan losses and the present level of the allowance for loan losses;
- results of examinations of our loan portfolios by regulatory agencies; and
- management s internal review of the loan portfolio.

We maintain an allowance for loan losses to cover expected loan losses inherent in our loan portfolio. Additional loan losses will likely occur in the future and may occur at a rate greater than we have experienced to date.

In determining the size of the allowance, we rely on an analysis of our loan portfolio, our experience and our evaluation of general economic conditions. While we are not currently aware of any fact or circumstance that would cause our allowance to be inadequate, if our assumptions prove to be incorrect, our current allowance may not be sufficient. Adjustments may also be necessary to allow for unexpected volatility or deterioration in the local or national economy. Material additions to the allowance would materially decrease our net income. In addition, federal regulators periodically evaluate the adequacy of our allowance and may require us to increase our provision for loan and lease losses or recognize further

loan charge-offs, based on judgments different than those of our management. Any increase in our allowance or loan charge-offs as required by these regulatory agencies could have a material adverse effect on our results of operations.

We operate in a highly competitive industry and market area.

We face substantial competition in all areas of our operations from a variety of different competitors, many of which are larger and may have more financial resources. Such competitors primarily include national, regional, and community banks within the various markets we operate. Additionally, various out-of-state banks conduct significant business in the market areas in which we currently operate. We also face competition from many other types of financial institutions, including, without limitation, savings and loans, credit unions, finance companies, brokerage firms, insurance companies, factoring companies and other financial intermediaries.

The financial services industry could become even more competitive as a result of legislative, regulatory and technological changes and continued consolidation. Banks, securities firms and insurance companies can merge under the umbrella of a financial holding company, which can offer virtually any type of financial service, including banking, securities underwriting, insurance (both agency and underwriting) and merchant banking. Also, technology has lowered barriers to entry and made it possible for non-banks to offer products and services traditionally provided by banks, such as automatic transfer and automatic payment systems. Many of our competitors have fewer regulatory constraints and may have lower cost structures. Additionally, due to their size, many competitors may be able to achieve economies of scale and, as a result, may offer a broader range of products and services as well as better pricing for those products and services than we can.

Our ability to compete successfully depends on a number of factors, including, among other things:

- The ability to develop, maintain and build upon long-term customer relationships based on top quality service, high ethical standards and safe, sound assets;
- The ability to expand our market position;
- The scope, relevance and pricing of products and services offered to meet customer needs and demands;
- The rate at which we introduce new products and services relative to its competitors;
- Customer satisfaction with our level of service; and
- Industry and general economic trends.

Failure to perform in any of these areas could significantly weaken our competitive position, which could adversely affect our growth and profitability, which, in turn, could have a material adverse effect on our financial condition and results of operations.

We may be unable to comply with the requirements of the Cease and Desist Order relating to compliance with Bank Secrecy Act regulations, which could result in regulatory restrictions on our operations.

Under the terms of the Order, as discussed in SUPERVISION AND REGULATION Anti-Money Laundering Initiatives and the USA Patriot Act, we are required to make specific improvements in our BSA compliance activities. If we are unable to satisfy the requirements imposed in the Order, we may be subject to or restrictions on our banking operations and future growth plans. Such measures could impair our reputation in the community, lead to the loss of customers and adversely affect our profitability and growth prospects.

Our deposit customers may pursue alternatives to bank deposits or seek higher yielding deposits, causing us to incur increased funding costs.

We are facing increasing deposit-pricing pressures. Checking and savings account balances and other forms of deposits can decrease when our deposit customers perceive alternative investments, such as the stock market or other non-depository investments, as providing superior expected returns. Furthermore, technology and other changes have made it more convenient for bank customers to transfer funds into alternative investments, including products offered by other financial institutions or non-bank service providers. Additional increases in short-term interest rates could increase transfers of deposits to higher yielding deposits. Efforts and initiatives we undertake to retain and increase deposits, including deposit pricing, can increase our costs. When bank customers move money out of bank deposits in favor of alternative investments or into higher yielding deposits, we can lose a relatively inexpensive source of funds, increasing our funding costs.

Operations in our mainland loan production offices have positively affected our results of operations, and sustaining these operations and growing loans may be more difficult than we expect, which could adversely affect our results of operations.

Sustaining the expansion of loan production on the mainland depends on a number of factors, including the continued strength of the California and Washington real estate markets. The strength of these real estate markets could be negatively affected by anticipated increases in interest rates and any economic downturn, and our results of operation could be negatively impacted.

Because we have a limited operating history with respect to our California and Washington loan production offices, it is more difficult to predict our future prospects and financial performance, which may impair our ability to manage our business.

Our first California loan production office commenced operations in the first quarter of 2003, and our first Washington loan production office opened in the fourth quarter of 2004. Consequently, our mainland offices have a limited history upon which we can rely in planning and making decisions that will affect our future operating results.

The loans made by our mainland loan production offices in California and Washington are generally unseasoned, and any defaults on such loans would adversely affect our financial condition, results of operations and prospects.

At December 31, 2006, loans originated in our California and Washington loan production offices totaled $1.1 billion, or 29% of our total loan portfolio. In light of the limited operating history of our mainland loan production offices described in the previous risk factor, all of those loans were originated after January 1, 2003. The payment on such loans is typically dependent on the cash flows generated by the projects, which are affected by the supply and demand for commercial property within the relative market. If the market for commercial property experiences a decline in demand, commercial borrowers may suffer losses on their projects and be unable to repay their loans. Defaults on these loans would negatively affect our financial condition, results of operations and prospects.

The loans made by our mainland loan production offices in California and Washington are concentrated among a limited number of customers in California and Washington, and difficulty with a customer or loss of a customer could affect our results of operations and our ability to grow loans and deposits in the mainland.

Our mainland operations are dependent on a concentration of loans with a small number of key customers with whom individuals on our mainland loan staff have built strong relationships. Such a concentration of borrowers carries certain risks. Among other things, financial difficulty at one mortgaged real property could cause a borrower to defer maintenance at another mortgaged real property in order to satisfy current expenses with respect to the troubled mortgaged real property. A borrower could attempt to avert foreclosure on one mortgaged real property by filing a bankruptcy petition that might have the effect of interrupting monthly payments for an indefinite period on all of the related mortgage loans. Furthermore, the average size of loans in our mainland portfolio, especially those originated in Southern California, is larger than that of loans in our Hawaii portfolio, and such larger average loan size could make potential losses related to concentration risk more severe.

Loan growth from our mainland operations is dependent on relationships between certain key customers and our current mainland loan staff who in turn have forged relationships with certain key members of our management team, and the departure of these individuals could adversely affect our business.

Our mainland operations are dependent on the relationships with customers built by our experienced teams of lenders, many of whom have worked with each other and with key individuals on our senior management team. If some or all of our mainland loan officers, or the members of our senior management staff who coordinate mainland operations, were to leave our company, it could adversely affect the expansion of our mainland operations and our ability to grow loans.

We are subject to environmental liability risk associated with lending activities.

A significant portion of our loan portfolio is secured by real property. During the ordinary course of business, we may foreclose on and take title to properties securing certain loans. In doing so, there is a risk that hazardous or toxic substances could be found on these properties. If hazardous or toxic substances are found, we may be liable for remediation costs, as well as for personal injury and property damage. Environmental laws may require us to incur substantial expenses and may materially reduce the affected property s value or limit our ability to use or sell the affected property. In addition, future laws or more stringent interpretations or enforcement policies with respect to existing laws may increase our exposure to environmental liability. Although we require an environmental review before initiating any foreclosure action on real property, these other financial liabilities associated with an environmental hazard could have a material adverse effect on our financial condition and results of operations.

Governmental regulation may impair our operations or restrict our growth.

We are subject to significant governmental supervision and regulation. These regulations are intended primarily for the protection of depositors. Statutes and regulations affecting our business may be changed at any time, and the interpretation of these statutes and regulations by examining authorities may also change. Within the last several years Congress and the President have passed and enacted significant changes to these statutes and regulations. There can be no assurance that such changes to the statutes and regulations or to their interpretation will not adversely affect our business. In addition to governmental supervision and regulation, we are subject to changes in other federal and state laws, including changes in tax laws, which could materially affect the banking industry. We are subject to the rules and regulations of the FRB. If we fail to comply with federal and state bank regulations, the regulators may limit our activities or growth, fine us or ultimately put us out of business. Banking laws and regulations change from time to time. Bank regulations can hinder our ability to compete with financial services companies that are not regulated in the same manner or are less regulated. Federal and state bank regulatory agencies regulate many aspects of our operations. These areas include:

- the capital that must be maintained;
- the kinds of activities that can be engaged in;
- the kinds and amounts of investments that can be made;

- the locations of offices;
- insurance of deposits and the premiums that we must pay for this insurance; and
- how much cash we must set aside as reserves for deposits.

We may be unsuccessful in our federal or Hawaii state tax appeals, or ongoing tax audits may result in additional tax liabilities.

We are currently appealing certain tax assessments by the Internal Revenue Service and the State of Hawaii Department of Taxation. While we believe that we have properly applied the relevant income tax statutes and have obtained supporting opinions from tax consultants, we may be unsuccessful in one or more of our appeals. While we have established contingency reserves as deemed appropriate, adverse decisions or settlements could result in income tax and related interest exposure in excess of amounts reserved. The potential tax exposure that has not been reserved amounted to $4.1 million at December 31, 2006. A discussion of significant tax positions is provided in note 17 to the Consolidated Financial Statements.

Our controls and procedures may fail or be circumvented.

Management regularly reviews and updates our internal controls, disclosure controls and procedures, and corporate governance policies and procedures. Any system of controls, however well designed and operated, is based in part on certain assumptions and can provide only reasonable, not absolute, assurances that the objectives of the system are met. Any failure or circumvention of our controls and procedures or failure to comply with regulations related to controls and procedures could have a material adverse effect on our business, results of operations and financial condition.

We face risks associated with future acquisitions.

Our ability to obtain regulatory approval of acquisitions is subject to constraints related to the Bank Secrecy Act and the CRA, as described below in Management s Discussion and Analysis of Financial Condition and Results of Operations. Subject to our ability to successfully address these regulatory concerns, we may pursue future acquisition opportunities. Risks commonly encountered in existing and future acquisitions include, among other things:

- The difficulty of integrating the operations and personnel of acquired companies and branches;
- The potential disruption of our ongoing business;
- The potential diversion of our management s time and attention;
- The inability of our management to maximize our financial and strategic position by the successful implementation of uniform product offerings and the incorporation of uniform technology into our product offerings and control systems;
- The inability of our management to comply with reporting requirements;
- The inability to maintain uniform standards, controls, procedures and policies and the impairment of relationships with employees and customers as a result of changes in management;
- The potential exposure to unknown or contingent liabilities of the acquired company;
- Exposure to potential asset quality issues of the acquired company;
- The possible loss of key employees and customers of the acquired company;
- Difficulty in estimating the value of the acquired company; and

- Potential changes in banking or tax laws or regulations that may affect the acquired company.

We may not be successful in overcoming these risks or any other problems encountered in connection with acquisitions. Our integration of operations of banks or branches that we acquire may not be successfully accomplished and may take a significant amount of time. Our inability to improve the operating performance of banks and branches we have acquired or to successfully integrate their operations could have a material adverse effect on our business, financial condition, results of operations and cash flows. We expect to hire additional employees and retain consultants to assist with integrating our operations, and we cannot assure you that those individuals or firms will perform as expected or be successful in addressing these issues.

Our growth and expansion may strain our ability to manage our operations and our financial resources.

Continued growth may present operating and other problems that could adversely affect our business, financial condition and results of operations. Our growth may place a strain on our administrative, operational, personnel and financial resources and increase demands on our systems and controls. We anticipate that our business growth may require continued enhancements to and expansion of our operating and financial systems and controls and may strain or significantly challenge them. Our inability to continue to upgrade or maintain effective operating and financial control systems and to recruit and hire necessary personnel or to successfully integrate new personnel into our operations could adversely impact our financial condition, results of operations and cash flows. In addition, we cannot assure you that our existing operating and financial control systems and infrastructure will be adequate to maintain and effectively monitor future growth.

New lines of business or new products and services may subject us to additional risks.

From time to time, we may implement new lines of business or offer new products and services within existing lines of business. There are substantial risks and uncertainties associated with these efforts, particularly in instances where the markets are not fully developed. In developing and marketing new lines of business and/or new products and services we may invest significant time and resources. Initial timetables for the introduction and development of new lines of business and/or new products or services may not be achieved and our price and profitability targets may not prove feasible. External factors, such as compliance with regulations, competitive alternatives, and shifting market preferences, may also impact the successful implementation of a new line of business or a new product or service. Furthermore, any new line of business and/or new product or service could have a significant impact on the effectiveness of our system of internal controls. Failure to successfully manage these risks in the development and implementation of new lines of business or new products or services could have a material adverse effect on our business, results of operations and financial condition.

We rely on dividends from our subsidiaries for most of our revenue.

Because we are a holding company with no significant assets other than our bank, we currently depend upon dividends from our bank for a substantial portion of our revenues. Our ability to pay dividends will therefore continue to depend in large part upon our receipt of dividends or other capital distributions from our bank. Our ability to pay dividends is subject to the restrictions of the Hawaii law.

The ability of the banks to pay dividends or make other capital distributions to us is also subject to the regulatory authority of the FDIC and Hawaii law as further described in the Supervision and Regulation section of Item 1. Business. As of December 31, 2006, Central Pacific Bank could have paid, in the aggregate, approximately $223.6 million in dividends without the prior approval of the FDIC.

We may not be able to attract and retain skilled people.

Our success depends, in large part, on our ability to attract and retain key people, and there are a limited number of qualified persons with knowledge of and experience in the banking industry in each of our markets. Furthermore, recent demand for skilled finance and accounting personnel among publicly traded companies has increased the importance of attracting and retaining these people. Competition for the best people can be intense given the tight labor market in Hawaii and we may not be able to hire people or to retain them. The unexpected loss of services of one or more of our key personnel could have a material adverse impact on our business because of their skills, knowledge of our market, years of industry experience and the difficulty of promptly finding qualified replacement personnel.

Our information systems may experience an interruption or breach in security.

We rely heavily on communications and information systems to conduct our business. Any failure, interruption or breach in security of these systems could result in failures or disruptions in our customer relationship management, general ledger, deposit, loan and other systems. While we have policies and procedures designed to prevent or limit the effect of the failure, interruption or security breach of our information systems, there can be no assurance that any such failures, interruptions or security breaches will not occur or, if they do occur, that they will be adequately addressed. The occurrence of any failures, interruptions or security breaches of our information systems could damage our reputation, result in a loss of customer business, subject us to additional regulatory scrutiny, or expose us to civil litigation and possible financial liability, any of which could have a material adverse effect on our financial condition and results of operations.

We continually encounter technological change.

The financial services industry is continually undergoing rapid technological change with frequent introductions of new technology-driven products and services. The effective use of technology increases efficiency and enables financial institutions to better serve customers and to reduce costs. Our future success depends, in part, upon our ability to address the needs of our customers by using technology to provide products and services that will satisfy customer demands, as well as to create additional efficiencies in our operations. Many of our competitors have substantially greater resources to invest in technological improvements. We may not be able to effectively implement new technology-driven products and services or be successful in marketing these products and services to its customers. Failure to successfully keep pace with technological change affecting the financial services industry could have a material adverse impact on our business and, in turn, our financial condition and results of operations.

We are subject to claims and litigation pertaining to fiduciary responsibility.

From time to time, customers make claims and take legal action pertaining to our performance of our fiduciary responsibilities. Regardless of whether customer claims and legal action related to our performance of our fiduciary responsibilities are founded or unfounded, if such claims and legal actions are not resolved in a manner favorable to us, they may result in significant financial liability and/or adversely affect the market perception of us and our products and services as well as impact customer demand for our products and services. Any financial liability or reputational damage could have a material adverse effect on our business, which, in turn, could have a material adverse effect on our financial condition and results of operations.

Severe weather, natural disasters, acts of war or terrorism and other external events could significantly impact our business.

Severe weather, natural disasters, acts of war or terrorism and other adverse external events could have a significant impact on our ability to conduct business. Such events could affect the stability of our deposit base, impair the ability of borrowers to repay outstanding loans, impair the value of collateral securing loans, cause significant property damage, result in loss of revenue and/or cause us to incur additional expenses. Although management has established disaster recovery policies and procedures, the occurrence of any such event could have a material adverse effect on our business, which, in turn, could have a material adverse effect on our financial condition and results of operations.

The earnings of financial services companies are significantly affected by general business and economic conditions.

Our operations and profitability are impacted by general business and economic conditions in the United States and abroad. These conditions include short-term and long-term interest rates, inflation, money supply, political issues, legislative and regulatory changes, fluctuations in both debt and equity capital markets, broad trends in industry and finance, and the strength of the U.S. economy and the local economies in which we operate, all of which are beyond our control. Deterioration in economic conditions could result in an increase in loan delinquencies and non-performing assets, decreases in loan collateral values and a decrease in demand for our products and services, among other things, any of which could have a material adverse impact on our financial condition and results of operations.

Financial services companies depend on the accuracy and completeness of information about customers and counterparties.

In deciding whether to extend credit or enter into other transactions, we may rely on information furnished by or on behalf of customers and counterparties, including financial statements, credit reports and other financial information. We may also rely on representations of those customers, counterparties or other third parties, such as independent auditors, as to the accuracy and completeness of that information. Reliance on inaccurate or misleading financial statements, credit reports or other financial information could have a material adverse impact on our business and, in turn, our financial condition and results of operations.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

Certifications

The Company has filed the required certifications under Section 302 of the Sarbanes-Oxley Act of 2002 as Exhibits 31.1 and 31.2 to this annual report on Form 10-K for the fiscal year ended December 31, 2006. Last year, the Company submitted to the New York Stock Exchange on May 18, 2006 its annual CEO certification regarding the Company s compliance with the NYSE s corporate governance listing standards required by NYSE rule 303A.12. This year, the Company intends to submit to the NYSE its annual CEO certification within 30 days of the Company s annual meeting of shareholders, which is scheduled for May 22, 2007.

ITEM 2. PROPERTIES

We hold title to the land and building in which our headquarters, Kaimuki branch office, Hilo branch office, Kailua-Kona branch office, Pearl City branch office, and certain operations offices are located. We also hold title to the buildings in which our Moiliili, McCully, Kalihi and Beretania branch offices and operations center are located, a portion of the land underlying a commercial office building in which our residential mortgage lending subsidiary is housed, as well as a portion of land on which the Moiliili branch office and the data processing operations offices are located. The remaining lands on which the Moiliili branch and the data processing operations offices are located, as well as all of the land on which the McCully, Kalihi and Beretania branch offices are located, are leased. We also own four floors of a commercial office condominium in downtown Honolulu where certain administrative and support operations are located.

We occupy or hold leases for approximately 50 other properties including our remaining branch offices, a data processing center, seven loan production and support offices in California and Washington. These leases expire on various dates through 2038 and generally contain renewal options for periods ranging from five to 15 years. For additional information relating to lease rental expense and commitments, see Note 16 to the Consolidated Financial Statements.

ITEM 3. LEGAL PROCEEDINGS

Certain claims and lawsuits have been filed or are pending against us. In the opinion of management, all such matters are without merit or are of such kind that if disposed of unfavorably, would not have a material adverse effect on our consolidated results of operations or financial position.

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

No matters were submitted to our shareholders for a vote during the fourth quarter of 2006.

PART II

ITEM 5. MARKET FOR REGISTRANT S COMMON EQUITY, RELATED SHAREHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Our common stock is traded on the New York Stock Exchange (NYSE) under the ticker symbol CPF. Set forth below is a line graph comparing the cumulative total stockholder return on the Company s common stock, based on the market price of the common stock and assuming reinvestment of dividends, with the Russell 2000 Index and the S&P SmallCap 600 Commercial Bank Index for the five year period commencing December 31, 2001 and ending December 31, 2006. The graph assumes the investment of $100 on December 31, 2001.

Indexed Total Annual Return
(as of December 31, 2006)

The following table sets forth information on the range of high and low sales prices of our common stock, as reported by the NYSE, for each full quarterly period within 2006 and 2005:

	Years Ended December 31,			
	2006		**2005**	
	High	**Low**	**High**	**Low**
First quarter	$ 39.33	$ 33.55	$ 38.79	$ 33.20
Second quarter	$ 40.15	$ 33.30	$ 37.68	$ 31.10
Third quarter	$ 39.48	$ 34.34	$ 37.82	$ 33.10
Fourth quarter	$ 39.79	$ 35.50	$ 38.28	$ 31.87

As of December 31, 2006, there were 3,488 shareholders of record, excluding individuals and institutions for which shares were held in the names of nominees and brokerage firms.

Dividends

We have paid regular quarterly cash dividends since 1988. The following table sets forth information on dividends declared per share of common stock for each quarterly period within 2006 and 2005:

	Years Ended December 31,	
	2006	**2005**
First quarter	$ 0.21	$ 0.16
Second quarter	$ 0.21	$ 0.19
Third quarter	$ 0.23	$ 0.19
Fourth quarter	$ 0.23	$ 0.19

The holders of our common stock share proportionately on a per share basis in all dividends and other distributions declared by our board of directors. We expect to continue to pay regular quarterly cash dividends. However, since substantially all of the funds available for the payment of dividends are derived from our bank, future dividends will depend upon our bank s earnings, financial condition and capital needs, applicable governmental policies and regulations and such other matters as our board of directors may deem to be appropriate.

Our ability to pay cash dividends is further subject to our continued payment of interest that we owe on our junior subordinated debentures. As of December 31, 2006, we had approximately $108 million of our junior subordinated debentures outstanding. We have the right to defer payment of interest on the junior subordinated debentures for a period not exceeding 20 consecutive quarters. If we defer, or fail to make, interest payments on the junior subordinated debentures, or if we fail to comply with certain covenants under the related indentures, we will be prohibited, subject to certain exceptions, from paying cash dividends on our common stock until we pay all deferred interest and resume interest payments on the junior subordinated debentures and until we comply with the covenants under the related indentures.

Our ability to pay dividends is also limited by certain restrictions imposed on Hawaii corporations. We may pay dividends out of funds legally available at such times as our board of directors determines are appropriate. For information regarding the dividend payments made by Central Pacific Financial Corp. and its subsidiaries see the discussion under the section captioned Capital Resources, included in Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations and Note 23 in the notes to consolidated financial statements included in Item 8. Financial Statements and Supplementary Data.

Issuer Purchases of Equity Securities

We did not purchase any of our equity securities during the fourth quarter of 2006.

Information relating to compensation plans under which equity securities of the Registrant are authorized for issuance is set forth in Part III, Item 12 of this Annual Report on Form 10-K.

ITEM 6. SELECTED FINANCIAL DATA

The following table sets forth selected financial information for each of the years in the five-year period ended December 31, 2006. This information is not necessarily indicative of results of future operations and should be read in conjunction with Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations and the Consolidated Financial Statements and related Notes to Consolidated Financial Statements contained in Item 8. Financial Statements and Supplementary Data..

	Year Ended December 31,				
Selected Financial Data	**2006**	**2005**	**2004**	**2003**	**2002**
	(Dollars in thousands, except per share data)				
Statement of Income Data:					
Total interest income	$ 320,381	$ 263,250	$ 150,389	$ 110,231	$ 118,462
Total interest expense	109,532	66,577	30,217	20,178	29,483
Net interest income	210,849	196,673	120,172	90,053	88,979
Provision for loan losses	1,350	3,917	2,083	700	1,000
Net interest income after provision for loan losses	209,499	192,756	118,089	89,353	87,979
Other operating income	43,156	41,002	22,018	15,834	15,282
Other operating expense	132,163	124,772	86,131	55,578	55,023
Income before income taxes	120,492	108,986	53,976	49,609	48,238
Income taxes	41,312	36,527	16,582	15,669	14,955
Net income	79,180	72,459	37,394	33,940	33,283
Balance Sheet Data (Year-End):					
Interest-bearing deposits in other banks	$ 5,933	$ 9,813	$ 52,978	$ 5,145	$ 39,358
Investment securities(1)	898,358	925,285	850,821	540,785	527,512
Loans	3,846,004	3,552,749	3,099,830	1,443,154	1,289,892
Allowance for loan losses	52,280	52,936	50,703	24,774	24,197
Goodwill	297,883	303,358	284,712		
Core deposit premium	31,898	35,795	49,188		
Total assets	5,487,192	5,239,139	4,651,902	2,170,268	2,028,163
Core deposits(2)	2,860,926	2,814,435	2,716,973	1,419,100	1,280,471
Total deposits	3,844,483	3,642,244	3,327,026	1,753,284	1,641,101
Long-term debt	740,189	749,258	587,380	184,184	147,155
Total shareholders equity	738,139	676,234	567,862	194,599	173,443
Per Share Data:					
Basic earnings per share	$ 2.60	$ 2.42	$ 1.90	$ 2.12	$ 2.09
Diluted earnings per share	2.57	2.38	1.87	2.07	2.04
Cash dividends declared	0.88	0.73	0.64	0.64	0.40
Book value	24.04	22.22	20.17	12.11	10.86
Diluted weighted average shares outstanding (in thousands)	30,827	30,487	20,017	16,397	16,326
Financial Ratios:					
Return on average assets	1.50 %	1.48 %	1.25 %	1.64 %	1.74 %
Return on average shareholders equity	11.16	11.16	12.37	18.33	20.55
Net income to average tangible shareholders equity	21.01	22.88	18.45	18.33	20.55
Efficiency ratio(3)	49.67	49.59	57.77	51.94	52.17
Net interest margin(4)	4.55	4.63	4.51	4.79	5.11
Net charge-offs to average loans	0.05	0.05	0.06	0.01	0.04
Nonperforming assets to year-end loans & other real estate(5)	0.23	0.35	0.35	0.25	0.18
Allowance for loan losses to year-end loans	1.36	1.49	1.64	1.72	1.88
Allowance for loan losses to nonaccrual loans	583.61	421.77	492.79	688.74	5,511.85
Dividend payout ratio	33.85	30.17	33.68	30.19	19.14

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(1) Held-to-maturity securities at amortized cost, available-for-sale securities at fair value.

(2) Noninterest-bearing demand, interest-bearing demand and savings deposits, and time deposits under $100,000.

(3) Efficiency ratio is derived by dividing other operating expense excluding amortization of intangible assets by net operating revenue (net interest income on a taxable equivalent basis plus other operating income before securities transactions).

(4) Computed on a taxable equivalent basis using an assumed income tax rate of 35%.

(5) Nonperforming assets include nonaccrual loans and other real estate.

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

Introduction

We are a bank holding company that, through our banking subsidiary, Central Pacific Bank, offers full service commercial banking in the state of Hawaii. In addition, we have six loan production offices serving customers in California and Washington.

Our products and services focus on two areas:

- *Loans*: We focus our lending activities on commercial, commercial mortgage and construction loans to small and medium-sized companies, business professionals and real estate developers. Our lending activities contribute to a key component of our revenues interest income.

- *Deposits*: We strive to provide exceptional customer service and products that meet our customers needs, like our Exceptional Account and Totally Free Checking and maintenance of a broad branch and ATM network in the state of Hawaii. Raising funds through our deposit accounts enables us to support our lending activities. The interest paid on such deposits has a significant impact on our interest expense, an important factor in determining our earnings. In addition, fees and service charges on deposit accounts contribute to our revenues.

In addition, we offer wealth management products and services such as non-deposit investment products, annuities, insurance, investment management, asset custody and general consultation and planning services.

In this discussion, we have included statements that may constitute forward-looking statements within the meaning of the safe harbor provisions of The Private Securities Litigation Reform Act of 1995. These forward-looking statements are not historical facts but instead represent only our beliefs regarding future events, many of which, by their nature, are inherently uncertain and beyond our control. These statements relate to our future plans and objectives, among other things. By identifying these statements for you in this manner, we are alerting you to the possibility that our actual results may differ, possibly materially, from the results indicated in the forward-looking statements. Important factors that could, among others, cause our results to differ, possibly materially, from those indicated in the forward-looking statements are discussed above under Business–Factors that May Affect Our Business in Part I, Item 1 of this Annual Report on Form 10-K.

Executive Overview

2006 can be characterized as a year of accomplishments and challenges.

- We experienced an 8.3% increase in our loan portfolio, led by strong growth in construction lending.

- Deposits increased by 5.6% despite a very competitive environment.

- We posted net income of $79.2 million, representing record earnings for our Company.

- We agreed to a cease and desist order with the FDIC and the DFI requiring us to improve compliance with the detection, monitoring and reporting requirements of the Bank Secrecy Act.

Our primary focus in 2006 was expanding and solidifying deposit relationships to support our strong loan demand and to mitigate the impact of competitive factors and interest rate-driven shifts in deposit composition. We also dedicated significant attention to enhancing our risk monitoring systems and improving our compliance processes. Asset quality remained strong, with a net loan charge-off ratio of 0.05% for the year and the ratio of nonperforming assets to loans and other real estate of 0.23% as of year-end 2006. Our key profitability measures held steady, with net income to average tangible shareholders equity at 21.01%, return on average assets at 1.50% and the efficiency ratio at 49.67%. For a further discussion of these trends and other factors affecting our business, see Overview of Results of Operations.

An annual examination of the bank by the FDIC and DFI identified weaknesses in our BSA compliance program that resulted in the issuance of a cease and desist order. We have devoted substantial attention and increased resources to the remediation of deficiencies in our compliance efforts and expect to fully comply with the Order by mid-year 2007. See SUPERVISION AND REGULATION Anti-Money Laundering Initiatives and USA Patriot Act, for further discussion.

Business Environment

The majority of our operations are concentrated in the states of Hawaii and California, and to a lesser extent, Washington. Accordingly, our business performance is directly affected by conditions in the banking industry, macro economic conditions and real estate market in those states. A favorable business environment is generally characterized by expanding gross state product, low unemployment and rising personal income.

General economic conditions in Hawaii moderated in 2006 after two years of exceptional growth in 2004 and 2005. Tourism remains Hawaii s most significant economic driver, and according to the Hawaii Department of Business Economic Development & Tourism (DBEDT), 7.4 million visitors visited the state in 2006, down slightly from the record 7.5 million visitor arrivals in 2005. However, increased daily visitor spending boosted total visitor spending to a record $12 billion, an increase of 2.9% over 2005. The Department of Labor and Industrial Relations reported that Hawaii s unemployment rate was 2.0% in December 2006, compared to 2.7% in December 2005. Hawaii s unemployment rate ranked the lowest among the 50 states, well below the national unemployment rate of 4.5%. The DBEDT projects real personal income growth to approximate 2.1% in 2006, and remain in the 2.1-2.3% range in 2007 through 2009. The DBEDT also projects Real Gross State Product growth of 3.3% in 2006 and approximately 2.4% growth per annum in the next three years.

With real estate lending as a primary focus, including construction loans, residential mortgages and commercial mortgages, we are also dependent on the strength of the real estate market. Following several years of strong growth, the Hawaii real estate market cooled in 2006. According to the Honolulu Board of Realtors, for the full year 2006, Oahu unit sales volume was down 13% for single-family homes and down 20% for condominiums. Additionally, the median sales prices in 2006 for single-family homes and condominiums on Oahu were $630,000 and $310,000, respectively, representing increases of 7% and 15%, respectively, over the median prices in 2005. Expectations are for the Hawaii real estate market to continue to moderate with slight declines in unit sales volumes and sales prices likely in 2007.

The economy in California also experienced moderate growth in 2006. Over the 12 months ending in October 2006, California nonfarm employment grew by 163,800 jobs, or 1% from a year ago, according to the California Department of Finance (CDOF). CDOF also reported that California s unemployment rate in October 2006 of 4.5% was the state s lowest in at least 30 years. The California Association of Realtors (CAR) reported that December 2006 unit home sales declined 15%, while the median price increased 4%, from year ago levels. CAR forecasts a modest decline in home prices and unit sales in 2007.

The Washington economy continued to expand led by gains at Microsoft and Boeing. According to the Washington State Employment Security Department, the seasonally adjusted unemployment rate was 5.0% in December 2006, a decrease of 0.2% from the year-ago rate. From the Washington State Economic and Revenue Forecast Council, or ERFC, total payroll employment in Washington rose 3% in fiscal 2006, up from 2% in 2005. Booming construction growth coupled with strong growth in both aerospace and software accounted for the improved employment picture. Employment growth is forecasted to moderate over the next year due to a leveling off of construction employment and slower aerospace employment growth. The Washington Center for Real Estate Research reported that third quarter 2006 unit home sales declined 16%, while the median price increased 12%, from year ago levels.

Critical Accounting Policies and Use of Estimates

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

Allowance for Loan Losses We maintain the allowance for loan losses, or the Allowance, at an amount we expect to be sufficient to absorb probable losses inherent in our loan portfolio based on a projection of probable net loan charge-offs. For loans classified as impaired, an estimated impairment loss is calculated. To estimate net loan charge-offs on other loans, we evaluate the level and trend of nonperforming and potential problem loans and historical loss experience. We also consider other relevant economic conditions and borrower-specific risk characteristics, including current repayment patterns of our borrowers, the fair value of collateral securing, specific loans, changes in our lending and underwriting standards and general economic factors, nationally and in the markets we serve. Estimated loss rates are determined by loan category and risk profile, and an overall required Allowance is calculated. Based on our estimate of the level of Allowance required, a provision for loan losses, or the Provision, is recorded to maintain the Allowance at an appropriate level.

Since we cannot predict with certainty the amount of loan charge-offs that will be incurred, and because the eventual level of loan charge-offs are impacted by numerous conditions beyond our control, a range of loss estimates could reasonably have been used to determine the Allowance and Provision. In addition, various regulatory agencies, as an integral part of their examination processes, periodically review the Company s Allowance. Such agencies may require the Company to recognize additions to the Allowance based on their judgments about information available to them at the time of their examination. Accordingly, actual results could differ from those estimates.

Goodwill and Other Intangible Assets In accordance with Statement of Financial Accounting Standards (SFAS) No. 142, *Goodwill and Other Intangible Assets* (SFAS 142), we review the carrying amount of goodwill for impairment on an annual basis. Additionally, we perform an impairment assessment of goodwill and other intangible assets whenever events or changes in circumstances indicate that the carrying value of goodwill and other intangible assets may not be recoverable. Significant changes in circumstances can be both internal to our strategic and financial direction, as well as changes to the competitive and economic landscape.

Our impairment assessment of goodwill and other intangible assets involves the estimation of future cash flows and the fair value of reporting units to which goodwill is allocated. Estimating future cash flows and determining fair values of the reporting units is judgmental and often involves the use of significant estimates and assumptions. These estimates and assumptions could have a significant impact on whether or not an impairment charge is recognized and also the magnitude of the impairment charge.

Deferred Tax Assets and Tax Contingencies We account for income taxes in accordance with SFAS 109, *Accounting for Income Taxes.* Deferred taxes assets and liabilities are recognized for the estimated future tax effects attributable to temporary differences and carryforwards. A valuation allowance may be required if, based on the weight of available evidence, it is more likely than not that some portion or all of the deferred tax assets will not be realized. In determining whether a valuation allowance is necessary, we consider the level of taxable income in prior years, to the extent that carrybacks are permitted under current tax laws, as well as estimates of future taxable income and tax planning strategies that could be implemented to accelerate taxable income if necessary. If our estimates of future taxable income were materially overstated, or if our assumptions regarding the tax consequences of tax planning strategies were inaccurate, some or all of our deferred tax assets may not be realized, which would result in a charge to earnings.

We have established income tax reserves for potential tax liabilities related to uncertain tax positions. Tax benefits are recognized when it is deemed probable that such benefits will be realized. Where uncertainty exists due to the complexity of income tax statutes, and where ethe potential tax amounts are significant, we generally seek independent tax opinions to support our positions. If our evaluation of the likelihood of favorable outcome is inaccurate, we could incur additional income tax and interest expense than would adversely impact earnings, or we could receive tax benefits greater than anticipated which would positively impact earnings.

Defined Benefit Retirement Plan Defined benefit plan obligations and related assets of our defined benefit retirement plan are presented in Note 14 to the Consolidated Financial Statements. Plan assets, which consist primarily of marketable equity and debt securities, are typically valued using market quotations. Plan obligations and the annual pension expense are determined by independent actuaries through the use of a number of assumptions. Key assumptions in measuring the plan obligations include the discount rate and the expected long-term rate of return on plan assets. In determining the discount rate, we utilize a yield that reflects the top 50% of the universe of bonds, ranked in the order of the highest yield. Asset returns are based upon the anticipated average rate of earnings expected on the invested funds of the plans.

At December 31, 2006, we used a weighted-average discount rate of 5.9% and an expected long-term rate of return on plan assets of 8.0%, which affected the amount of pension liability recorded as of year-end 2006 and the amount of pension expense to be recorded in 2007. At December 31, 2005, a weighted-average discount rate of 5.7% and an expected long-term rate of return on plan assets of 8.0% were used in determining the pension liability recorded as of year-end 2005 and the amount of pension expense recorded in 2006. For both the discount rate and the asset return rate, a range of estimates could reasonably have been used which would affect the amount of pension expense and pension liability recorded.

An increase in the discount rate or asset return rate would reduce pension expense in 2006, while a decrease in the discount rate or asset return rate would have the opposite effect. A 0.25% change in the discount rate assumption would impact 2007 pension expense by $0.1 million and year-end 2006 pension liability by $0.7 million, while a 0.25% change in the asset return rate would impact 2007 pension expense by $0.1 million.

Overview of Results of Operations

Our net income in 2006 of $79.2 million increased by $6.7 million, or 9.3%, over the $72.5 million earned in 2005, which increased by $35.1 million, or 93.8%, over the $37.4 million earned in 2004. Net income in 2006 included after-tax charges totaling $3.8 million relating to executive retirement expenses, income tax liability adjustments, investment securities portfolio repositioning and an employee benefit-related liabilities adjustment that are not expected to recur in 2007. The increase in net income in 2006 reflected growth in net interest income and other operating income which more than offset increased operating expenses. The substantial increase in our net income in 2005 was principally a result of the full year effect and the merger of CBBI, as compared to the three and one half months of combined earnings in 2004. Diluted earnings per share of $2.57 increased by $0.19 or 8.0% compared to the $2.38 earned in

2005, which increased by 27.3% from the $1.87 earned in 2004. Cash dividends declared of $0.88 per common share increased by 20.5% over the dividends of $0.73 per share declared in 2005, which increased by 14.1% over the dividends of $0.64 per share declared in 2004. Return on average assets of 1.50% in 2006 increased slightly over the 1.48% in 2005, which increased from 1.25% in 2004.

Return on average equity was 11.16% in 2006 and 2005, compared to 12.37% in 2004. Our efficiency ratio, which measures operating expenses before intangible amortization as a percentage of tax-equivalent total revenue, was 49.67%, compared to 49.59% in 2005 and 57.77% in 2004. The significant items affecting the comparability of the five years performance include: (1) $2.3 million in stock option expense recognized in 2006 in accordance with Statement of Financial Accounting Standards No. 123R, Share-Based Payment (SFAS 123R); (2) $2.1 million in executive retirement expenses incurred in 2006; (3) $1.1 million in tax charges for income tax liability adjustments in 2006; (4) $5.5 million, $9.3 million and $1.4 million in nonrecurring integration, severance and merger-related expenses incurred in 2005, 2004 and 2003, respectively; (5) incremental earnings of HHL since August 17, 2005 and of CBBI since September 15, 2004, the effective dates of the respective acquisitions; (6) issuance of 2.0 million shares of common stock in a public offering in March 2005 and 11.9 million shares of common stock in September 2004 in connection with the CBBI acquisition; and (7) net amortization of core deposit premium and other purchase accounting valuation adjustments, and interest expense on trust preferred securities issued to finance the CB Bancshares acquisition.

Net Interest Income

Table 1 sets forth information concerning average interest earning assets and interest-bearing liabilities and the yields and rates thereon. Table 2 presents an analysis of changes in components of net interest income between years. Interest income, which includes loan fees, and resultant yield information presented in the tables and discussed in this section are expressed on a taxable equivalent basis using an assumed income tax rate of 35%.

Table 1. Average Balances, Interest Income and Expense, Yields and Rates (Taxable Equivalent)

	2006			2005			2004		
	Average Balance (Dollars in thousands)	Average Yield/ Rate	Amount of Interest	Average Balance	Average Yield/ Rate	Amount of Interest	Average Balance	Average Yield/ Rate	Amount of Interest
Assets									
Interest earning assets:									
Interest-bearing deposits in other banks	$ 11,919	4.61 %	$ 550	$ 13,205	2.64 %	$ 349	$ 18,400	1.57 %	$ 289
Federal funds sold	2,880	4.97	143	5,956	2.87	171	5,989	1.50	90
Taxable investment securities(1)	799,583	4.42	35,313	807,216	4.25	34,336	579,635	4.21	24,385
Tax-exempt investment securities(1)	136,809	5.71	7,815	130,889	6.21	8,125	103,944	6.61	6,867
Loans(2)	3,689,979	7.57	279,246	3,301,277	6.75	222,841	1,986,872	6.07	120,684
Federal Home Loan Bank stock	48,797	0.10	49	48,749	0.56	272	24,725	1.92	475
Total interest earning assets	4,689,967	6.89	323,116	4,307,292	6.18	266,094	2,719,565	5.62	152,790
Nonearning assets	581,677			575,933			281,213		
Total assets	$ 5,271,644			$ 4,883,225			$ 3,000,778		
Liabilities and Shareholders Equity									
Interest-bearing liabilities:									
Interest-bearing demand deposits	$ 426,828	0.13 %	$ 566	$ 429,798	0.17 %	$ 730	$ 238,201	0.16 %	$ 381
Savings and money market deposits	1,153,651	1.53	17,684	1,131,964	0.69	7,859	851,354	0.45	3,795
Time deposits under $100,000	590,335	2.84	16,750	548,043	2.00	10,953	312,809	1.69	5,297
Time deposits $100,000 and over	876,513	4.18	36,669	684,938	2.75	18,844	428,672	1.72	7,390
Short-term borrowings	41,401	5.31	2,197	56,757	3.27	1,858	36,756	2.00	735
Long-term debt	755,378	4.72	35,666	660,992	3.98	26,333	361,181	3.49	12,619
Total interest-bearing liabilities	3,844,106	2.85	109,532	3,512,492	1.90	66,577	2,228,973	1.36	30,217
Noninterest-bearing deposits	628,736			634,035			412,701		
Other liabilities	89,558			87,699			56,704		
Shareholders equity	709,244			648,999			302,400		
Total liabilities and shareholders equity	$ 5,271,644			$ 4,883,225			$ 3,000,778		
Net interest income			$ 213,584			$ 199,517			$ 122,573
Net interest margin		4.55 %			4.63 %			4.51 %	

(1) At amortized cost.

(2) Includes nonaccrual loans.

Table 2. Analysis of Changes in Net Interest Income (Taxable Equivalent)

	2006 Compared to 2005 Increase (Decrease) Due to Change In:			2005 Compared to 2004 Increase (Decrease) Due to Change In:		
	Volume	Rate	Net Change	Volume	Rate	Net Change
	(Dollars in thousands)					
Interest earning assets						
Interest-bearing deposits in other banks	$ (34)	$ 235	$ 201	$ (82)	$ 142	$ 60
Federal funds sold	(88)	60	(28)		81	81
Taxable investment securities	(324)	1,301	977	9,581	370	9,951
Tax-exempt investment securities	368	(678)	(310)	1,781	(523)	1,258
Loans	26,237	30,168	56,405	79,784	22,373	102,157
Federal Home Loan Bank stock		(223)	(223)	461	(664)	(203)
Total interest earning assets	26,159	30,863	57,022	91,525	21,779	113,304