

**FEDERAL DEPOSIT INSURANCE CORPORATION**  
Washington, D.C. 20429

**FORM 10-K**

Mark One

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

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

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

**PREFERRED BANK**

(Exact name of registrant as specified in its charter)

California  
(State or other jurisdiction of incorporation or organization)

33539  
(FDIC Certificate Number)

95-4340199  
(I.R.S. Employer Identification No.)

601 S. Figueroa Street, 20th Floor, Los Angeles, California  
(Address of principal executive offices)

90017  
(Zip Code)

Registrant's telephone number, including area code: (213) 891-1188

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

Title of each class	Name of each exchange on which registered
NONE	NONE

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

Common Stock, No Par Value  
(Title of class)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes  No

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 or 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 the Form 10-K or any amendment to this Form 10-K.

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

Large accelerated filer  Accelerated filer  Non-accelerated filer

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

The aggregate market value of the voting and non-voting common equity held by non-affiliates of the Registrant, computed by reference to the price at which the common equity was last sold as of the last business day of the Registrant's most recently completed second fiscal quarter (June 30, 2006) was \$365,615,053

Number of shares of common stock of the Registrant outstanding as of March 29, 2007, was 10,414,132.

The following documents are incorporated by reference herein:

**Document Incorporated By Reference**

**Part of Form 10-K Into Which Incorporated**

Definitive Proxy Statement for the Annual Meeting of Shareholders which will be filed within 120 days of the fiscal year ended December 31, 2006 . . . . .

Part III

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## PART I

Certain matters discussed in this Annual Report on Form 10-K may constitute forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended (the “1933 Act”) and Section 21E of the Securities Exchange Act of 1934, as amended (the “Exchange Act”), and as such, may involve risks and uncertainties. These forward-looking statements relate to, among other things, expectations of the environment in which the Bank operates and projections of future performance. The Bank’s actual results, performance, or achievements may differ significantly from the results, performance, or achievements expected or implied in such forward-looking statements. For discussion of some of the factors that might cause such differences, see “Item 1. BUSINESS—Risk Factors That May Affect Future Results.”

### ITEM 1. BUSINESS

#### General

We are one of the largest independent commercial banks in California focusing on the Chinese-American market. We consider the Chinese-American market to encompass individuals born in the United States of Chinese ancestry, ethnic Chinese who have immigrated to the United States and ethnic Chinese who live abroad but conduct business in the United States.

We commenced operations in December 1991 as a California state-chartered bank in Los Angeles, California with initial capital of \$20 million. At December 31, 2006, total assets were \$1.3 billion, loans and leases were \$997.3 million, deposits were \$1.2 billion and shareholders’ equity was \$145.9 million. Net income per share on a diluted basis was \$2.21 for the year ended December 31, 2006 as compared to \$1.65 per share for the year ended December 31, 2005.

We provide personalized deposit services as well as real estate finance, commercial loans and trade finance to small and mid-sized businesses and their owners, entrepreneurs, real estate developers and investors, professionals and high net worth individuals. We believe we have benefited, and will continue to benefit from the significant migration to Southern California of ethnic Chinese from China and other areas of East Asia. We estimate that at December 31, 2006, approximately 66% of our non-governmental deposits and 22% of our loans were with customers from the Chinese-American market. While our business is not solely dependent on the Chinese-American market, it represents an important element of our operating strategy, especially for our branch network and deposit products and services.

On February 17, 2005, we completed an initial public offering (“IPO”) of 3,657,000 shares of our common stock at \$25.33 per share in a firm commitment underwritten offering. The number of shares sold included 477,000 shares sold pursuant to the underwriters’ exercise of their over-allotment option. Of the 3,657,000 shares sold, Preferred Bank sold 1,478,433 shares and 2,178,567, shares were sold by certain selling shareholders. The net proceeds to us from our IPO of common stock were approximately \$35 million (before expenses). The number of shares and per share data has been adjusted to reflect our February 20, 2007 three-for-two stock split effected in the form of a dividend.

We had used the net proceeds from our IPO for general corporate purposes, working capital, financing internal growth, and expanding of new branches and loan portfolios.

Our main office is located at 601 S. Figueroa Street, 20th Floor, Los Angeles, CA 90017 and our telephone number is (213) 891-1188. Our internet address is [www.preferredbank.com](http://www.preferredbank.com). On our Investor Relations website, which can be accessed through [www.preferredbank.com](http://www.preferredbank.com), we post the following filings as soon as reasonably practicable after they are filed with or furnished to the Federal Deposit Insurance Corporation: our annual report on Form 10-K, our quarterly reports on Form 10-Q, our current reports on Form 8-K, our proxy statement related to our annual stockholders’ meeting and any amendments to those reports or statements filed or furnished

pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934. All such filings on our Investor Relations website are available free of charge. The reference to our website address does not constitute incorporation by reference of the information contained in the website and should not be considered part of this document. A copy of our Code of Personal and Business Conduct, including any amendments thereto or waivers thereof and Board Committee Charters can also be accessed on our website. We will provide, at no cost, a copy of our Code of Personal and Business Conduct and Board Committee Charters upon request by phone or in writing at the above phone number or address, attention: Edward J. Czajka, Senior Vice President and Chief Financial Officer.

## **Our Customers**

We provide a range of deposit and loan products and services to customers primarily within the following categories:

- *Real Estate Finance*—consisting of investors and developers within the real estate industry and of owner-occupied properties in Southern California. We do not typically provide single-family residential mortgages. We provide construction loans and mini-permanent (“mini-perm”) loans for residential, commercial, industrial and other income producing properties. A portion of our real estate loans are to borrowers who are also international trade finance customers.
- *Middle Market Business*—consisting of manufacturing, service and distribution companies with annual sales of approximately \$5 million to \$100 million and with borrowing requirements of up to approximately \$12 million. We offer a range of lending products to customers in this market, including working capital loans, equipment financing and commercial real estate loans. Additionally, we provide a full range of deposit products and related services including safe deposit boxes, account reconciliation, courier service and cash management services.
- *International Trade Finance*—consisting of importers and exporters based in the U.S. requiring both borrowing and operational products. We offer a full range of products to international trade finance customers, including commercial and standby letters of credit, acceptance financing, documentary collections, foreign draft collections, international wires and foreign exchange.
- *Private Banking*—consisting of wealthy individuals residing in the Pacific Rim area with residences, real estate investments or businesses in Southern California. We offer all of our banking products and services to this segment through our multi-lingual team of professionals knowledgeable in the business environment and financial affairs of Pacific Rim countries. We believe our language capabilities provide us with a competitive advantage.
- *Professionals*—consisting generally of physicians, accountants, attorneys, business managers and other professionals. We provide specialized personal banking services to customers in this segment including courier service, several types of specialized deposit accounts and personal and business loans as well as lines of credit.
- We provide a fully operating traditional internet banking system with bill pay services for these customers

## **Our Market**

From our main office in downtown Los Angeles, California and full-service branch banking offices in Los Angeles and Orange Counties, we market our services and conduct our business primarily in Los Angeles, Orange, Ventura, Riverside and San Bernardino counties.

We believe that Chinese-Americans continue to be the largest Asian ethnic group in Los Angeles County. According to the U.S. Census 2000, between 1990 and 2000, the Chinese-American population in the United States grew by approximately 48% with 40% of all Chinese-Americans living in California. During this same

period, it is estimated that the Chinese-American population in Los Angeles grew by 34%. According to the U.S. Census Bureau, as of 2003, 364,469 or approximately 30% of Asian-Americans living in Los Angeles County were Chinese-Americans (excluding Taiwanese).

We believe that continuing consolidation of banks generally in Southern California, and among the banks serving the Chinese-American market in particular, has created an underserved market of small and mid-sized businesses, real estate developers and investors and high net worth depositors that we can continue to attract as customers.

We believe we are well positioned to compete effectively with the Chinese-American community banks, the larger commercial banks and major publicly listed and foreign bank-owned Chinese banks operating in Southern California by offering the following:

- deposit and cash management services to high net worth depositors with a high degree of personal service and responsiveness;
- experienced, multi-lingual management team and staff who have an understanding of Asian markets and cultures who we believe can provide sophisticated credit solutions faster and more efficiently and with a higher degree of personal service than what is provided by our competition; and
- loan products to customers requiring credit of a size in excess of what can be provided by our smaller competitors.

## **Our Strategy**

We strive to continue operating as a high performing community bank for the long-term benefit of our shareholders, customers and employees. The key elements of our growth and operating strategy are to:

### ***Growth Strategies***

- *Continue to grow our real estate lending activities* by providing competitive commercial real estate loans, construction loans and other real estate loans. We believe that we will have the ability to originate larger loans to new and existing customers.
- *Expand our franchise* by establishing new branches in Southern California. We may open additional branches by the end of 2007.
- *Expand our commercial lending relationships* in an effort to increase our noninterest bearing deposit accounts and our noninterest income. We expect to enhance our commercial loan portfolio by expanding existing customer relationships, as well as by devoting additional marketing resources to the Chinese-American and main stream business community in Southern California.
- *Expand our portfolio of products and services to high net worth customers* who we believe prefer to address their deposit and credit needs in a personal manner with experienced, efficient and service-oriented bank officers.
- *Hire and retain experienced and qualified employees* to support our planned expansion of our business activities.

### ***Operating Strategies***

- *Maintain high asset quality* independent of production goals by continuing to utilize rigorous loan underwriting standards and credit risk management policies.
- *Access capital markets* as needed and enhance our equity-based compensation programs through the increased liquidity provided by being a public company.

- *Increase revenue opportunities* by increasing our investments in higher yielding floating rate loans and investment securities and reducing the percentage of our investments in federal funds sold and other overnight investments.
- *Increase our operating leverage* by:
  - expanding sources of funding in addition to deposits to fund our loan and securities portfolios, such as borrowings from the Federal Home Loan Bank system;
  - changing the mix of our securities and loan portfolios to reduce the effect of regulatory asset risk weighting consistent with our yield parameters to permit additional asset growth without requiring additional capital; and

### **Our Lending Activities**

We originate a variety of types of loans, most of which fall into the following four categories:

- Real estate mini-perm loans;
- Real estate construction loans;
- Commercial loans; and
- Trade finance.

In addition to these loan types, we make a small amount of consumer loans principally as an accommodation to our business customers. We also utilize our relationships within the banking industry to purchase and sell participations in loans that meet our underwriting criteria. As of December 31, 2006, we had a total of \$190.4 million in purchased loans and \$50.0 million in loans that we sold. We manage our loan portfolio to provide for an adequate return, but also to provide a diversification of risk.

We originate our loans from our eleven banking offices in Los Angeles, Orange, and San Bernardino counties. For mini-perm and construction loans, we rely on referrals from existing clients who are real estate investors and developers as well as internal business development efforts. For our commercial and trade finance lending, we seek referrals from existing banking clients as well as referrals from professionals, such as certified public accountants, attorneys and business managers.

At December 31, 2006, 85% of our loans carried interest rates that adjust with changes in the Prime Rate, 13% carried interest rates tied to LIBOR or other indices and 2% carried a fixed rate. Approximately 37% of our loan portfolio has an interest rate floor.

The following table sets forth information regarding our four major loan categories:

	<u>At December 31, 2006</u> (Dollars in thousands)
<b><i>Real Estate Mini-Perm</i></b>	
Portfolio size .....	\$438,280
Number of loans .....	206
Average loan size .....	\$ 2,128
Average LTV <sup>(1)</sup> .....	54.02%
Average DCR <sup>(2)</sup> .....	1.70%
Weighted average rate .....	8.89%
<b><i>Real Estate Construction</i></b>	
Portfolio size .....	\$271,021
Number of loans .....	101
Average loan size .....	\$ 2,683
Average LTV <sup>(1)</sup> .....	59.96%
Weighted average rate .....	9.14%
<b><i>Commercial Loans</i></b>	
Portfolio size .....	\$201,385
Number of loans .....	390
Average loan size .....	\$ 516
Weighted average rate .....	8.25%
<b><i>Trade Finance</i></b>	
Portfolio size .....	\$ 86,067
Number of loans .....	126
Average loan size .....	\$ 683
Weighted average rate .....	8.46%

- (1) Average loan-to-value, or LTV, is calculated based upon a weighted average of outstanding principal loan balances (for mini-perm loans) or commitment (for construction loans) divided by the most recent third party appraisal reports. Third party appraisal reports are only an estimate of the value of the property at the time the appraisal is made.
- (2) Average debt coverage ratio, or DCR, is calculated based upon the net operating income of the property divided by the debt service.

We had 183 loans with outstanding principal balances between \$1 million to \$5 million, 29 loans with outstanding balances between \$5 million and \$10 million, and 18 loans over \$10 million as of December 31, 2006.

#### *Real Estate Mini-Perm Loans*

Real estate mini-perm loans secured by retail, office and residential multi-family properties have been the fastest growing segment of our loan portfolio and comprise 44% of our loan portfolio as of December 31, 2006. We believe the primary reason for this growth is strong demand for commercial and residential multi-family real estate in Southern California. We seek diversification through maintaining a broad base of borrowers and monitoring our exposure to various property types.



The following table sets forth the breakdown of our real estate mini-perm portfolio by property type:

<u>Property Type</u>	<u>At December 31, 2006</u>	
	<u>Amount</u>	<u>Percentage of Loans in Each Category in Total Loan Portfolio</u>
		<u>(Dollars in thousands)</u>
Commercial/Office .....	\$ 75,456	7.56%
Industrial .....	67,857	6.80
Retail .....	64,594	6.48
Apartment 4+ .....	25,019	2.51
Residential 1-4 .....	52,043	5.22
Land/Special purpose .....	153,311	15.37
Total .....	<u>\$438,280</u>	<u>43.94%</u>

The following table sets forth the maturity of our real estate mini-perm loan portfolio:

<u>At December 31, 2006</u>						
<u>1-Year</u>	<u>2-Years</u>	<u>Less than 3-Years</u>	<u>4-Years</u>	<u>5-Years</u>	<u>More than 5-Years</u>	<u>Total Outstanding Balance</u>
			<u>(In thousands)</u>			
\$166,075	\$53,562	\$51,948	\$59,294	\$45,001	\$62,400	\$438,280

*Loan Origination.* The loan origination process for mini-perm loans begins by a loan officer collecting preliminary property information and financial data from a prospective borrower. After a preliminary deal sheet is prepared and approved by management, the loan officer collects the necessary third party reports such as appraisals, credit reports, environmental assessments and preliminary title reports as well as detailed financial information. We utilize third party appraisers from an appraiser list approved by our Board of Directors' loan committee. From that list, appraisers for loans under \$1.2 million are selected by the individual loan officer, appraisers for loans between \$1.2 million and \$3.0 million are selected by the loan officer with the concurrence of the Chief Credit Officer and appraisers for loans over \$3.0 million are selected by the Chief Credit Officer.

All appraisals for loans over \$1.2 million are reviewed by an additional outside appraiser. Appraisals for loans under that amount are reviewed by internal staff. A credit memorandum is then prepared by summarizing all third party reports and preparing an analysis of the adequacy of primary and secondary repayment sources; namely the property DCR and LTV as well as the outside financial strength and cash flow of the borrower or guarantor(s). This completed credit memorandum is then submitted to an officer or committee having the appropriate authority for approval. For further information on our different levels of authority, see "—Loan Authorizations" below.

Once a loan is approved by the appropriate authority level, loan documents are drawn by our note department, which also funds the loan when approval conditions are met. On larger, relatively complex transactions, loan documents are prepared or reviewed by outside legal counsel.

*Underwriting Standards.* Our principal underwriting standards for real estate mini-perm loans are as follows:

- Maximum LTV of 80%-85%, depending on the property type. However, our practice is to lend at more conservative levels.
- Minimum DCR of 1.2-1.25, depending on the property type.
- Requirements of personal guarantees from the principals of closely-held entity.



*Monitoring.* We monitor our mini-perm portfolio in different ways. First, on loans over \$2 million, we conduct site inspections and gather rent rolls and operating statements on the subject properties at least annually. Using this information, we evaluate a given property’s ability to service present payment requirements, and we perform “stress testing” to evaluate the property’s ability to service debt at higher debt levels. Second, on an annual basis, we request updated financial information from our borrowers and/or guarantors to monitor their financial capacity.

The vast majority of our mini-perm loans carry a five year maturity. However, it has been our practice to renew these loans for additional five-year periods based on a satisfactory payment record and an updated underwriting profile.

*Real Estate Construction*

We are an active construction lender with construction loans comprising 27% of the total loan portfolio as of December 31, 2006. Construction loans are typically short-term loans of up to 18 months for the purpose of funding the costs of constructing a building. Outstanding construction loans by property type are summarized as follows:

<u>Property Type</u>	<u>At December 31, 2006</u>	
	<u>Amount</u>	<u>Percentage of Loans in Each Category in Total Loan Portfolio</u>
	<u>(Dollars in thousands)</u>	
Commercial/Office .....	\$ 11,477	1.15%
Retail .....	11,596	1.16
Industrial .....	2,612	0.26
For sale attached residential .....	133,302	13.36
For sale detached residential .....	56,673	5.68
Apartment .....	41,952	4.21
Land/Special purpose .....	13,409	1.35
Total .....	<u>\$271,021</u>	<u>27.17%</u>

*Loan Origination.* The origination process for construction loans is identical to our real estate mini-perm origination process described above under “—Real Estate Mini-Perm Loans—Loan Origination,” but with an additional step. We generally require a third party review of the developer’s proposed building costs.

*Underwriting Standards.* Our underwriting standards for construction loans are identical to those described above under “—Real Estate Mini-Perm Loans—Underwriting Standards.” For the for-sale-housing projects, however, the DCR requirement is not applicable. In addition, we require that the construction loan applicant has proven experience in the type of project we are considering. Finally, notwithstanding the maximum 80%-85% LTV discussed above under “—Real Estate Mini-Perm Loans—Underwriting Standards,” we generally require a maximum 70% LTV for construction loans.

*Monitoring.* The monitoring of construction loans is accomplished under the supervision of our Chief Credit Officer. We engage third-party inspectors to report on the percentage of project completion as well as to evaluate whether the project is proceeding at an acceptable pace. The third-party inspector also recommends whether we should approve or disapprove disbursement request amounts. The third-party inspector produces monthly reports on each project that contain the evaluation and recommendation for each project. The Chief Credit Officer reviews each report and makes a final determination regarding the disbursement requests. All approved disbursements are funded by the centralized note department.

### *Commercial Loans*

We offer a variety of commercial loan products including lines of credit for working capital, term loans for capital expenditures and commercial and stand-by letters of credit. As of December 31, 2006, we had \$201.4 million of commercial loans outstanding, which represented 20% of the overall loan portfolio. Lines of credit typically have a 12 month commitment and are secured by the borrower's assets. In cases of larger commitments, an updated certificate from the borrower may be required to determine eligibility at the time of any given advance. Term loans seldom exceed 60 months, but in no case exceed the depreciable life of the tangible asset being financed.

*Loan Origination.* A commercial loan begins with a loan officer obtaining preliminary financial information from the borrower and guarantors and summarizing the loan request in a deal sheet. The deal sheet is then reviewed by senior management and/or those who have the loan authority to approve the credit. Following preliminary approval, the loan officer undertakes a formal underwriting analysis, including third party credit reports and asset verifications. From this information and analysis, a credit memorandum is prepared and submitted to an officer or committee having the appropriate approval authority for review. After approval, the note department prepares loan documentation reflecting the conditions of approval and funds the loan when those conditions are met.

*Underwriting Standards.* Our underwriting standards for commercial loans are designed to identify, measure and quantify the risk inherent in these types of credits. Our underwriting process and standards help us identify the primary and secondary repayment sources. The following are our major underwriting guidelines:

- Cash flow is our primary underwriting criteria. We require a minimum 1.5:1 DCR for our commercial loans. We also review trends in the borrower's sales levels, gross profit and expenses.
- We evaluate the borrower's financial statements to determine whether a given borrower's balance sheet provides for appropriate levels of equity and working capital.
- Since most of our borrowers are closely held companies, we require the principals to guarantee the company debt. Our underwriting process, therefore, includes an evaluation of the guarantor's net worth, income and credit history. Where circumstances warrant, we may require guarantees be secured by collateral (generally with real estate).
- Where there is a reliance on the accounts receivable and inventory of a company, we evaluate their condition, which may include third party onsite audits.

*Monitoring.* For those borrowers whose credit availability is tied to a formula based on advances as a percentage of accounts receivable and inventory (typically 80% and 50%, respectively), we review monthly borrowing base certificates for both availability and turnover trends. Periodically, we also conduct third party onsite audits, the frequency of which is dependent on the individual borrower. On a quarterly basis, we monitor the financial performance of a borrower by analyzing the borrower's financial statements for compliance with financial covenants.

### *Trade Finance Credits*

Our trade finance portfolio totaled \$86.1 million, or approximately 9% of our total loan portfolio as of December 31, 2006. Of this amount, virtually all loans were made to U.S. based importers who are also our current borrowers or depositors. We also provide standby letters of credit and foreign exchange services to our clients. Our new trade finance credit relationships result from contacts and relationships with existing clients, CPAs and trade facilitators such as customs brokers. In many cases, the ability to generate new trade finance business is also a result of cultivated social contacts and extended family.

We offer the following services to importers:

- Commercial letters of credit;
- Import lines of credit;
- Documentary collections;
- International wire transfers; and
- Acceptances / trust receipt financing.

We offer the following services to exporters:

- Export letters of credit;
- Export finance;
- Documentary collections;
- Bills purchase program; and
- International wire transfers.

*Loan Origination.* Our trade finance origination process is equivalent to our commercial loan process. Since we lend only to U.S. based companies, our due diligence process is equivalent to that of our commercial loan process with an emphasis on evaluating and verifying the assets of the borrowers and principals.

*Underwriting Standards.* Trade finance underwriting standards are based on our commercial loan standards. Typically, these loans are secured by receivables and inventories with advance rates similar to that of commercial loans. In many cases, we also require real estate or cash as partial collateral to further enhance our collateral position. However, in underwriting these credits, we also analyze the borrower's working capital requirements with a greater focus on the trade cycle and seasonality of the inventory being imported. Often an importer needs to order product months in advance, which requires us to structure the credit to accommodate the issuance of letters of credit early in the season and to carry accounts receivable after shipping.

*Monitoring.* We monitor trade finance credits by reviewing monthly borrowing base certificates of accounts receivable and inventory for both availability and turnover trends and tracking loan covenants on a quarterly basis. To supplement our review of borrowing bases, we utilize the services of third party accounts receivable and inventory auditors for certain credits. Finally, it is accepted trade finance practice to fund the payment of letters of credit on a "tenor" basis. That means that an advance under the trade finance line has a maturity (commonly 90 days). This serves as a self-monitoring mechanism because a matured and unpaid advance is a possible indicator of poor accounts receivable and/or inventory turnover.

## **Loan Concentrations**

As of December 31, 2006 and 2005, the concentration of loans secured by real estate in our total loan portfolio were approximately 71% and 71%, respectively. A substantial decline in the performance of the economy in general, or a decline in real estate values in the Bank's primary market areas, in particular, could have an adverse impact on collectibility, increase the level of real estate-related non-performing loans or have other adverse effects which alone or in the aggregate could have a material adverse effect on our business, financial condition, results of operations and cash flows.

Our real estate loans by type of collateral are as follows:

<u>Property Type</u>	<u>At December 31, 2006</u>	
	<u>Amount</u>	<u>Percentage of Loans in Each Category in Total Loan Portfolio</u>
		<u>(Dollars in thousands)</u>
Commercial/Office .....	\$ 86,933	8.71%
Retail <sup>(1)</sup> .....	76,190	7.64
Industrial .....	70,469	7.06
1-4 family .....	242,018	24.26
Multi-family .....	66,971	6.72
Land/Special purpose <sup>(2)</sup> .....	166,720	16.72
Total .....	<u>\$709,301</u>	<u>71.11%</u>

(1) Includes shopping centers, strip malls or stand-alone properties which house retailers.

(2) Examples, other than land, include hospitality and self-storage.

To manage the risks inherent in this concentration in our loan portfolio, we have adopted a number of policies and procedures. For example, we have adopted regulatory loan-to-value standards that must be met at the time of origination, which are summarized below:

<u>Collateral Type</u>	<u>LTV Maximum</u>
Occupied 1-4 .....	90%
Unimproved land .....	65%
Land development .....	75%
Improved properties .....	85%
Construction .....	80-85%
Commercial construction .....	80%
1-4 SFR construction .....	85%

Our underwriting practice, however, is to lend at lower LTV's. At December 31, 2006, the weighted average LTV of our real estate portfolio based on LTVs at the time of origination was 57.4%.

Our practice is to require DCR's on commercial real estate loans of 1.2 to 1.25x, depending on the property type. We also underwrite our commercial real estate loans using a rate that is 1-2% greater than the proposed interest rate on the loan.

In addition, we have established certain concentration limits for our real estate lending activities by property type. Our other real estate loan limitations include out of area (California) lending at no more than 15% of our portfolio. At December 31, 2006, 4.4% of our real estate portfolio was secured by real estate located outside of California.

## Loan Maturities

In addition to measuring and monitoring concentrations in our loan portfolio, we also monitor the maturities and interest rate structure of our portfolio. The following table shows the amounts of loans and leases outstanding as of December 31, 2006 which, based on remaining scheduled repayments of principal, were due in one year or less, more than one year through five years, and more than five years. The table also presents, for loans and leases with maturities over one year, an analysis with respect to fixed interest rate loans and leases and floating interest rate loans and leases.

	At December 31, 2006				Rate Structure for Loans Maturing over One Year	
	Maturity				Fixed Rate	Floating Rate
	One Year or Less	One through Five Years	Over Five Years	Total		
	(In thousands)					
Real estate mini-perm . . . . .	\$166,075	\$209,805	\$62,400	\$438,280	\$17,528	\$254,677
Commercial . . . . .	118,321	79,429	3,635	201,385	343	82,721
Construction . . . . .	182,927	88,094	—	271,021	2,904	85,190
Trade finance . . . . .	72,083	13,984	—	86,067	—	13,984
Consumer . . . . .	45	—	—	45	—	—
Leases receivable and other . . . . .	185	334	—	519	334	—
Total . . . . .	<u>\$539,636</u>	<u>\$391,646</u>	<u>\$66,035</u>	<u>\$997,317</u>	<u>\$21,109</u>	<u>\$436,572</u>

The following table shows the amounts of loans and leases outstanding as of December 31, 2005, which, based on remaining scheduled repayments of principal, were due in one year or less, more than one year through five years, and more than five years. Demand or other loans having no stated maturity and no stated schedule of repayments are reported as due in one year or less. The table also presents, for loans and leases with maturities over one year, an analysis with respect to fixed interest rate loans and leases and floating interest rate loans and leases.

	At December 31, 2005				Rate Structure for Loans Maturing over One Year	
	Maturity				Fixed Rate	Floating Rate
	One Year or Less	One through Five Years	Over Five Years	Total		
	(In thousands)					
Real estate mini-perm . . . . .	\$ 99,866	\$195,934	\$76,451	\$372,251	\$13,563	\$258,822
Real estate construction . . . . .	125,397	46,249	—	171,646	—	46,249
Commercial . . . . .	112,878	34,482	2,068	149,428	208	36,342
Trade finance . . . . .	76,238	462	—	76,700	—	462
Consumer . . . . .	29	92	—	121	—	92
Leases receivable and other . . . . .	465	532	—	997	532	—
Total . . . . .	<u>\$414,873</u>	<u>\$277,751</u>	<u>\$78,519</u>	<u>\$771,143</u>	<u>\$14,303</u>	<u>\$341,967</u>

As reflected in this data, the maturity of our portfolio is divided generally between loans maturing within one year or less and loans maturing between one and five years. Most of our shorter maturity loans are commercial, construction and trade finance loans. Most of the loans that have maturities between one and five years are real estate-mini perm loans. Regardless of maturity, most of our loans have interest rates that adjust with changes in the Prime Rate.

## Loan Authorizations

- *Individual Authorities.* Individual loan officers have approval authority up to \$1.0 million for loans secured by first trust deeds or cash and up to \$500,000 for unsecured transactions. The Chief Executive Officer and the Chief Credit Officer have combined approval authority up to \$7.0 million for secured loans and up to \$5.0 million for unsecured loans.
- *Management Loan Committee.* The Management Loan Committee consists of the Chief Executive Officer, the Chief Credit Officer and senior commercial and real estate lending officers. It has approval authority up to \$19.5 million for secured loans and up to \$11.7 million for unsecured loans.
- *Board of Directors Loan Committee.* Our Board of Directors loan committee consists of three members of the board of directors. It has approval authority up to our legal lending limit, which was approximately \$39.1 million for real estate secured loans and \$23.4 million for unsecured loans at December 31, 2006. The Board of Directors loan committee also reviews all loan commitments granted in excess of \$1.0 million on a quarterly basis for the preceding quarter.

All individual loan authorities are granted by the loan committee of our Board of Directors and are based on the individual's demonstrated credit judgment and lending experience.

If a credit falls outside of the guidelines set forth in our lending policies, the loan is not approved until it is reviewed by a higher level of credit approval authority. Credit approval authority has three levels, as listed above from lowest to highest level. Policy exceptions for cash flow, waiver of guarantee, excessive LTV or bad credit require approval of the President or Chief Credit Officer regardless of size.

We believe that the current authority levels provide satisfactory management and a reasonable percentage of secondary review. Any conditions placed on loans in the approval process must be satisfied before our Chief Credit Officer will release loan documentation for execution. Our Chief Credit Officer and his staff work entirely independent of loan production and have full responsibility for all loan disbursements.

## Loan Grading and Loan Review

We seek to quantify the risk in our lending portfolio by maintaining a loan grading system consisting of eight different categories (Grades 1-8). The grading system is used to determine, in part, the provision for loan losses. The first four grades in the system are considered satisfactory. The other four grades range from a "special mention" category to a "loss" category. These four grades are further discussed below under the section subtitled "classified assets."

The originating loan officer initially assigns a grade to each credit as part of the loan approval process. Such grade may be changed as a loan application moves through the approval process.

Prior to funding, all new loans of \$1.0 million or over are reviewed by our Chief Credit Officer who may assign a different grade to the credit. The grade on each individual loan is reviewed at least annually by the loan officer responsible for monitoring the credit. The Board of Directors reviews monthly the aggregate amount of all loans graded as special mention, substandard or doubtful, and each individual loan that has a grade within such range. Additionally, changes in the grade for a loan may occur through any of the following means:

- monthly reviews by the Chief Credit Officer of a sample of loans approved under individual loan authority;
- annual reviews conducted by an outside loan reviewer of certain categories of loans determined by the Board of Directors' audit committee. In 2005 and 2006, the outside loan reviewer reviewed all loans to insiders in excess of \$400,000, watch list credits in excess of \$400,000 and a sample of larger loans in our loan portfolio;

- bank regulatory examinations; and
- monthly action plans submitted to the Chief Credit Officer by the responsible lending officers for each credit graded 5-8.

*Loan Delinquencies.* When a borrower fails to make a committed payment, we attempt to cure the deficiency by contacting the borrower to seek payment. Habitual delinquencies and loans delinquent 30 days or more are reviewed for possible changes in grading.

*Classified Assets.* Federal regulations require that each insured bank classify its assets on a regular basis. In addition, in connection with examinations of insured institutions, examiners have authority to identify problem assets, and, if appropriate, classify them. We use grades 5-8 of our loan grading system to identify potential problem assets.

The following describes grades 5-8 of our loan grading system:

- *Special Mention—Grade 5.* Generally these are assets that display negative trends or other causes for concern. This grade is regarded as a transition category. We will either upgrade the credit if meaningful progress is evident within six months, or downgrade the credit to a more severe grade as appropriate.
- *Substandard—Grade 6.* These are assets that in management’s judgment have potential weaknesses that may result in deterioration of the repayment prospects and, therefore, deserve the attention of management. Usually, these assets are long-term problems that are likely to remain and require management action plans. These loans exhibit an increasing reliance on collateral for repayment.
- *Doubtful—Grade 7.* These assets are inadequately protected by the current worth and paying capacity of the borrower or of the collateral pledged, if any. Although loss may not be imminent, if the weaknesses are not corrected, there is a good possibility that we will sustain some loss.
- *Loss—Grade 8.* Assets classified as “loss” are considered uncollectible and of such little value in the near term that their continuance as active assets is not warranted. This does not mean they have no recovery or salvage value.

## **Deposit Products and Other Sources of Funds**

Our primary sources of funds for use in our lending and investment activities consist of:

- deposits and related services;
- maturities and principal and interest payments on loans and securities; and
- other borrowings.

We closely monitor rates and terms of competing sources of funds and utilize those sources we believe to be the most cost effective, consistent with our asset and liability management policies.

*Deposits and Related Services.* We have historically relied primarily upon, and expect to continue to rely primarily upon, deposits to satisfy our needs for sources of funds. An important balance sheet component impacting our net interest margin is the composition and cost of our deposit base. We can improve our net interest margin to the extent that growth in deposits can be focused in the less volatile and somewhat more traditional core deposits, or total deposits less CDs greater than \$100,000, commonly referred to as Jumbo CDs.

We provide a wide array of deposit products. We offer regular checking, savings, NOW and money market deposit accounts; fixed-rate, fixed maturity retail certificates of deposit ranging in terms from 14 days to five years; and individual retirement accounts and non-retail certificates of deposit consisting of Jumbo CDs. We attempt to price our deposit products in order to promote deposit growth and satisfy our liquidity requirements. We provide courier service to pick up non-cash deposits, and for those customers that use large amounts of cash, we arrange for armored car and vault service.



We provide a high level of personal service to our high net worth individual customers who have significant funds available to invest. We believe our Jumbo CDs are a stable source of funding because they are based primarily on service and personal relationships with senior Bank officers rather than interest rate. Further, 3% of these Jumbo CDs are pledged as collateral for loans from us to the depositor or the depositor's affiliated business or family member. We monitor interest rates offered by our competitors and pay a rate we believe is competitive with the range of rates offered by such competitors.

We also receive a significant amount of our deposits from governmental agencies. At December 31, 2006, we had \$120.2 million in government agency deposits, or 10% of our total deposits. Generally, a condition to holding some of these deposits is that we must pledge qualifying government securities in the amount of 110% of the deposit we hold. At December 31, 2006, we had \$157.5 million of government securities pledged for the benefit of our government agency deposits.

From time to time, we also access the deposit broker market for deposits to meet short-term liquidity requirements. At December 31, 2006, we held \$52.4 million of deposits obtained in this manner. There were no significant rate differences between the rates on these deposits as compared to our internally generated Jumbo CDs.

We intend to focus our efforts on attracting deposits from our business lending relationships in order to reduce our cost of funds and improve our net interest margin. Also, we believe that we have the ability to attract sufficient additional funding by re-pricing the yields on our CDs in order to meet loan demands during times that growth rates in core deposits differ from loan growth rates.

In addition to the marketing methods listed above, we seek to attract new clients and deposits by:

- expanding long-term business customer relationships, including referrals from our customers, and
- building deposit relationships through our branch relationship officers.

*Other Borrowings.* We may occasionally use our federal funds lines of credit to support liquidity needs created by seasonal deposit flows, to temporarily satisfy funding needs from increased loan demand and for other short-term purposes. As of December 31, 2006, we have two federal funds lines with other financial institutions pursuant to which we can borrow up to \$80 million on an unsecured basis and an unsecured line of credit with the Federal Home Loan Bank of San Francisco or FHLBSF in the amount of \$24 million. At December 31, 2006, our secured borrowing line with the FHLBSF was \$101.7 million. The unsecured federal funds lines may be terminated by the respective lending institutions at any time. At December 31, 2006, we had \$0 outstanding under these federal funds lines.

We also borrow from the Federal Home Loan Bank, or FHLB, pursuant to an existing commitment based on the value of the collateral pledged (either loans or securities). We had \$20 million in outstanding FHLB advances with a weighted average interest rate of 3.71% and a remaining maturity greater than one year at December 31, 2006.

## **Our Investment Activities**

Our investment strategy is designed to be complementary to and interactive with our other strategies (*i.e.*, cash position; borrowed funds; quality, maturity, stability and earnings of loans; nature and stability of deposits; capital and tax planning). The target percentage for our investment portfolio is between 10% to 40% of total assets. Our general objectives with respect to our investment portfolio are to:

- achieve an acceptable asset/liability mix;
- provide a suitable balance of quality and diversification to our assets;
- provide liquidity necessary to meet cyclical and long-term changes in the mix of assets and liabilities;

- provide a stable flow of dependable earnings;
- maintain collateral for pledging requirements;
- manage and mitigate interest rate risk;
- comply with regulatory and accounting standards; and
- provide funds for local community needs.

Investment securities consist primarily of U.S. agency issues, investment grade corporate notes, municipal bonds and mortgage-backed securities. In addition, for bank liquidity purposes, we use (1) overnight federal funds, which are temporary overnight sales of excess funds to correspondent banks and (2) interest-bearing deposits at other financial institutions, which consist of certificates of deposit spread over many financial institutions to take advantage of 100% FDIC insured coverage.

As of December 31, 2006 the company classified all of its investment securities as “available-for-sale” pursuant to SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities*. Available for sale securities are reported at fair value, with unrealized gains and losses excluded from earnings and instead reported as a separate component of stockholders’ equity. Held to maturity securities would be securities that we have both the intent and the ability to hold to maturity. These securities would be carried at cost adjusted for amortization of premium and accretion of discount.

Our securities portfolio is managed in accordance with guidelines set by our investment policy. Specific day-to-day transactions affecting the securities portfolio are managed by our Chief Financial Officer. In accordance with our written investment policy, all executions also require the prior written approval of the CEO and President. These securities activities are reviewed periodically, as needed, by our investment committee and are reported to our Board of Directors.

Our investment policy addresses strategies, types and levels of allowable investments and is reviewed and approved annually by our Board of Directors. It also limits the amount we can invest in various types of securities, places limits on average life and duration of securities, and limits the securities dealers with whom we can conduct business.

### **Our Concentrations / Customers**

Except as described below, no individual or single group of related accounts is considered material in relation to our assets or deposits or in relation to our overall business. Approximately 71% of our loan portfolio at December 31, 2006 consisted of real estate-secured loans, including commercial loans secured by real estate, construction loans and real estate mini-perm loans. Moreover, our business activities are focused in Southern California. Consequently, our business is dependent on the trends of this regional economy, and in particular, the commercial real estate markets. At December 31, 2006, we had 230 loans in excess of \$1.0 million, totaling \$843.8 million. These loans comprise approximately 22% of our loan portfolio based on number of loans and 85% based on total loans outstanding balance. Excluding credit card and consumer overdraft lines, our average loan size is \$967,000.

At December 31, 2006, excluding government deposits, brokered deposits and deposits as direct collateral for loans, we had 18 depositors with deposits in excess of \$3.0 million totaled \$131million or 11.3% of our total deposits. In addition to these depositors, 139 depositors held a total of \$164 million or 14.1% of our total deposits.

### **Our Competition**

The banking and financial services business in Southern California is highly competitive. This increasingly competitive environment faced by banks is a result primarily of changes in laws and regulation, changes in

technology and product delivery systems, and the accelerating pace of consolidation among financial services providers. 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, money market funds, credit unions and other nonbank financial services providers. Many of these competitors are much larger in total assets and capitalization, have greater access to capital markets, including foreign ownership and/or offer a broader range of financial services than we can offer.

We also compete with three publicly listed Chinese-American banks, and subsidiary banks and branches of foreign banks, from countries such as Taiwan and China, many of which have greater lending limits, and a wider variety of products and services. We also compete with Chinese-American and mainstream community banks for both deposits and loans.

Competition for deposit and loan products remains strong from both banking and non-banking firms and this competition directly affects the rates of those products and the terms on which they are offered to consumers.

Technological innovation continues to contribute to greater competition in domestic and international financial services markets. Many customers now expect a choice of several delivery systems and channels, including telephone, mail, internet, ATMs, and remote deposit capture.

Mergers between financial institutions have placed additional pressure on banks to consolidate their operations, reduce expenses and increase revenues to remain competitive. In addition, competition has intensified due to federal and state interstate banking laws, which permit banking organizations to expand geographically with fewer restrictions than in the past. These laws allow banks to merge with other banks across state lines, thereby enabling banks to establish or expand banking operations in our market. The competitive environment is also significantly impacted by federal and state legislation that make it easier for non-bank financial institutions to compete with us.

## **Regulation and Supervision**

*The following discussion of statutes and regulations affecting banks is only a summary and does not purport to be complete. This discussion is qualified in its entirety by reference to such statutes and regulations. No assurance can be given that such statutes or regulations will not change in the future.*

### *General*

The Bank is extensively regulated under both federal and state laws. Regulation and supervision by the federal and state banking agencies is intended primarily for the protection of depositors and the Deposit Insurance Fund (“DIF”) administered by the Federal Deposit Insurance Corporation (“FDIC”), and not for the benefit of stockholders. Set forth below is a summary description of key laws and regulations which relate to the Bank’s operations. These descriptions are qualified in their entirety by reference to the applicable laws and regulations.

As a California state-chartered bank which is not a member of the Federal Reserve System, we are subject to supervision, periodic examination and regulation by the California Commissioner of Financial Institutions and the Department of Financial Institutions (“DFI”), as the Bank’s state regulator, and by the FDIC as the Bank’s primary federal regulator. The regulations of these agencies govern most aspects of our business, including the making of periodic reports by us, and our activities relating to dividends, investments, loans, borrowings, capital requirements, certain check-clearing activities, branching, mergers and acquisitions, reserves against deposits and numerous other areas. Supervision, legal action and examination of us by the FDIC is generally intended to protect depositors and is not intended for the protection of shareholders. If, as a result of an examination, either the DFI or the FDIC should determine that the financial condition, capital resources, asset quality, earnings prospects, management, liquidity, or other aspects of the Bank’s operations are unsatisfactory or that the Bank or

its management is violating or has violated any law or regulation, various remedies are available to the DFI and the FDIC. These remedies include the power to require affirmative action to correct any conditions resulting from any violation or practice; enter into informal nonpublic or formal public memoranda of understanding or written agreements with the Bank to take corrective action; issue an administrative cease and desist order that can be judicially enforced; direct an increase in capital; enjoin unsafe or unsound practices; restrict the Bank's growth; assess civil monetary penalties; and remove officers and directors. Ultimately the FDIC could terminate the Bank's FDIC insurance and the DFI could revoke the Bank's charter or take possession and close and liquidate the Bank.

The Bank's profitability, like most financial institutions, is primarily dependent on our ability to maintain a favorable differential or "spread" between the yield on our interest-earning assets and the rate paid on our deposits and other interest-bearing liabilities. In general, the difference between the interest rates paid by the Bank on interest bearing liabilities, such as deposits and other borrowings, and the interest rates received by the Bank on our interest-earning assets, such as loans extended to customers and securities held in our investment portfolio, will comprise the major portion of the Bank's earnings. These rates are highly sensitive to many factors that are beyond the control of the Bank, such as inflation, recession and unemployment, and the impact which future changes in domestic and foreign economic conditions might have on the Bank cannot be predicted.

The Bank's business is also influenced by the monetary and fiscal policies of the federal government, and the policies of the regulatory agencies, particularly the FRB. The FRB implements national monetary policies (with objectives such as curbing inflation and combating recession) through its open-market operations in United States government securities, by adjusting the required level of reserves for financial institutions subject to its reserve requirements and by varying the target federal funds and discount rates applicable to borrowings by depository institutions. The actions of the FRB in these areas influence the growth of bank loans, investments and deposits and also affect interest earned on interest-earning assets and paid on interest bearing liabilities. The nature and impact of any future changes in monetary and fiscal policies on the Bank cannot be predicted.

Changes such as the following in federal or state banking laws or the regulations, policies or guidance of the federal or state banking agencies could have an adverse cost or competitive impact on the Bank's operations:

- (i) In December 2006, the federal banking agencies issued final guidance to reinforce sound risk management practices for bank holding companies and banks in commercial real estate (CRE) loans which establishes CRE concentration thresholds as criteria for examiners to identify CRE concentration that may warrant further analysis. The implementation of these guidelines could result in increased reserves and capital costs for banks with "CRE concentration." Management believes that the Bank's CRE portfolio as of December 31, 2006 does not have the risks associated with high CRE concentration due to mitigating factors, including moderate loan-to-value ratios, adequate debt coverage ratios and a wide variety of property types.
- (ii) In September 2006 the federal banking agencies issued final guidance and subsequently in March 2007 proposed additional guidance on alternative or "nontraditional" residential mortgage products that allow borrowers to defer repayment of principal and sometimes interest, including "interest-only" mortgage loans, and "payment option" adjustable rate mortgages ("ARMs") where a borrower has flexible payment options, including payments that have the potential for negative amortization, and ARMs with low initial payments based on a fixed introductory or "teaser" rate that adjusts after a short initial period. While acknowledging that innovations in mortgage lending can benefit some consumers, the guidance states that management should (1) assess a borrower's ability to repay the loan, including any principal balances added through negative amortization, at the fully indexed rate that would apply after the introductory period; (2) recognize that certain nontraditional mortgages are untested in a stressed environment and warrant strong risk management standards as well as appropriate capital and loan loss reserves; and (3) ensure that borrowers have sufficient information to clearly understand loan terms and associated risks prior to making a product or payment choice. The Bank does not presently offer any mortgage products which are the subject of the banking agencies' present or proposed guidance.

(iii) Pursuant to the Financial Services Regulatory Relief Act of 2006, the SEC and the Federal Reserve have released, as Regulation R, joint proposed rules expected to be finalized by midyear to implement exceptions provided for in the Gramm-Leach-Bliley Act (“GLBA”) for bank securities activities which banks may conduct without registering with the SEC as securities brokers or moving such activities to a broker-dealer affiliate. The proposed Regulation R “push out” rules exceptions would allow a bank, subject to certain conditions, to continue to conduct securities transactions for customers as part of the Bank’s trust and fiduciary, custodial and deposit “sweep” functions, and to refer customers to a securities broker-dealer pursuant to a networking arrangement with the broker-dealer. The Bank does not presently engage in any securities activities.

Because California law permits commercial banks chartered by the state to engage in any activity permissible for national banks, the Bank may form subsidiaries to engage in the many so-called “closely related to banking” or “nonbanking” activities commonly conducted by national banks in operating subsidiaries, and, further, may conduct certain “financial” activities in a subsidiary to the same extent as may a national bank. Generally, a financial subsidiary is permitted to engage in activities that are “financial in nature” or incidental thereto, even though they are not permissible for the national bank to conduct directly within the bank. The definition of “financial in nature” includes, among other items, underwriting, dealing in or making a market in securities, including, for example, distributing shares of mutual funds. A financial subsidiary may not, however, under present law, engage as principal in underwriting insurance (other than credit life insurance), issue annuities or engage in real estate brokerage or development or in merchant banking activities. In order to form a financial subsidiary, the Bank must be “well-capitalized,” “well-managed” and in satisfactory compliance with the Community Reinvestment Act (“CRA”). Further, the Bank must exclude from its assets and capital all equity investments, including retained earnings, in a financial subsidiary, and the assets of a financial subsidiary may not be consolidated with the Bank’s assets. The Bank would also be subject to the same risk management and affiliate transaction rules that apply to national banks with financial subsidiaries.

The Bank is also subject to the requirements and restrictions of various consumer laws, regulations and the Community Reinvestment Act, or CRA.

### *Capital Standards*

The federal banking agencies have adopted risk-based minimum capital guidelines for banks which are intended to provide a measure of capital that reflects the degree of risk associated with a banking organization’s operations for both transactions reported on the balance sheet as assets, and transactions, such as letters of credit and recourse arrangements, which are recorded as off-balance-sheet items.

The risk-based capital ratio is determined by classifying assets and certain off-balance sheet financial instruments into weighted categories, with higher levels of capital being required for those categories perceived as representing greater risk. Under the capital guidelines, a banking organization’s total capital is divided into tiers. “Tier I capital” consists of (1) common equity, (2) qualifying noncumulative perpetual preferred stock, (3) a limited amount of qualifying cumulative perpetual preferred stock and (4) minority interests in the equity accounts of consolidated subsidiaries (including trust-preferred securities), less goodwill and certain other intangible assets. Qualifying Tier I capital may consist of trust-preferred securities, subject to certain criteria and quantitative limits for inclusion of restricted core capital elements in Tier I capital. “Tier II capital” consists of hybrid capital instruments, perpetual debt, mandatory convertible debt securities, a limited amount of subordinated debt, preferred stock and trust-preferred securities that do not qualify as Tier I capital, a limited amount of the allowance for loan and lease losses and a limited amount of unrealized holding gains on equity securities. “Tier III capital” consists of qualifying unsecured subordinated debt. The sum of Tier II and Tier III capital may not exceed the amount of Tier I capital.

The risk-based capital guidelines require a minimum ratio of qualifying total capital to risk-adjusted assets of 8.0%, and a minimum ratio of Tier 1 capital to risk-adjusted assets of 4.0%. In addition to the risk-based

guidelines, the federal bank regulatory agencies require banking organizations to maintain a minimum amount of Tier I capital to total assets, referred to as the leverage ratio. For a banking organization rated well capitalized, in the highest of the five categories used by regulators to rate banking organizations, the minimum leverage ratio of Tier I capital to total assets must be 3.0%.

An institution's risk-based capital, leverage capital and tangible capital ratios together determine the institution's capital classification. An institution is treated as well capitalized if its total capital to risk-weighted assets ratio is 10.00% or more; its core capital to risk-weighted assets ratio is 6.00% or more; and its core capital to adjusted total assets ratio is 5.00% or more. At December 31, 2006, the Bank's capital ratios exceed these minimum percentage requirements to be considered well capitalized.

The current risk-based capital guidelines are based upon the 1988 capital accord of the International Basel Committee on Banking Supervision. A new international accord, referred to as Basel II, which emphasizes internal assessment of credit, market and operational risk, supervisory assessment and market discipline in determining minimum capital requirements, currently becomes mandatory for large international banks outside the U.S. in 2008. In October 2006, the U.S. federal banking agencies issued a notice of proposed rulemaking for comment to implement Basel II for U.S. banks with certain differences from the international Basel II framework and which would not be fully in effect for U.S. banks until 2012. Further, the U.S. banking agencies propose to retain the minimum leverage requirement and prompt corrective action regulatory standards. In December 2006 the federal banking agencies issued another notice of proposed rulemaking for comment, referred to as Basel IA, that proposed alternative capital requirements for smaller U.S. banks which may be negatively impacted competitively by certain provisions of Basel II. Additional guidance issued in February 2007 stated the agencies' expectation that to determine the extent to which banks should hold capital in excess of regulatory minimum levels, examiners would examine the combined implications of a bank's compliance with qualification requirements for regulatory risk-based capital standards, the quality and results of the bank's internal capital adequacy assessment process, and the examiners' assessment of the bank's risk profile and capital position. At this time the impact that proposed changes in capital requirements may have on the cost and availability of different types of credit and the potential compliance cost to the Bank of implementing the requirements of the final rulemaking which is applicable to the Bank are uncertain.

A bank that does not achieve and maintain the required capital levels may be issued a capital directive by the FDIC to ensure the maintenance of required capital levels. As discussed above, we are required to maintain certain levels of capital. The regulatory capital guidelines as well as our actual capitalization as of December 31, 2006 is as follows:

<b>Leverage Ratio</b>	
Preferred Bank .....	11.50%
Minimum requirement for "Well-Capitalized institution .....	5.00%
Minimum regulatory requirement .....	4.00%
<b>Tier 1 Risk-Based Capital Ratio</b>	
Preferred Bank .....	11.52%
Minimum requirement for "Well-Capitalized institution .....	6.00%
Minimum regulatory requirement .....	4.00%
<b>Total Risk-Based Capital Ratio</b>	
Preferred Bank .....	12.33%
Minimum requirement for "Well-Capitalized institution .....	10.00%
Minimum regulatory requirement .....	8.00%

#### *Dividends and Other Transfers of Funds*

The Bank is subject to various statutory and regulatory restrictions on its ability to pay dividends. Under such restrictions, the amount available for payment of dividends totaled \$38.5 million at December 31, 2006. In



addition, the banking agencies have the authority to prohibit the Bank from paying dividends, depending upon the Bank's financial condition, if such payment would be deemed to constitute an unsafe or unsound practice.

#### *Prompt Corrective Action*

The FDIC also possesses broad powers under the Federal Deposit Insurance Act (the "FDI Act") to take "prompt corrective action" and other supervisory action to resolve the problems of insured depository institutions that fall within any undercapitalized category. An institution that, based upon its capital levels, is classified as well capitalized, adequately capitalized or undercapitalized may be treated as though it were in the next lower capital category if the appropriate federal banking agency, after notice and opportunity for hearing, determines that an unsafe or unsound condition or an unsafe or unsound practice warrants such treatment. At each successive lower capital category, an insured depository institution is subject to more restrictions.

In addition, the federal banking agencies have adopted non-capital safety and soundness standards to assist examiners in identifying and addressing potential safety and soundness concerns before capital becomes impaired. The guidelines set forth operational and managerial standards relating to: (i) internal controls, information systems and internal audit systems, (ii) loan documentation, (iii) credit underwriting, (iv) asset quality and growth, (v) earnings, (vi) risk management, and (vii) compensation and benefits.

#### *Subprime Lending Guidelines*

As a result of a number of federally insured financial institutions extending their lending risk selection standards to attract lower credit quality borrowers due to their loans having higher interest rates and fees, the federal banking regulatory agencies have jointly issued interagency guidance on subprime lending, including guidance issued in September 2006 and March 2007 on nontraditional residential mortgage products. Subprime lending involves extending credit to individuals with less than perfect credit histories. The guidelines consider subprime lending a high-risk activity that is unsafe and unsound if the risks associated with subprime lending are not properly controlled. The federal banking agencies expect regulatory capital one and one-half to three times higher than that typically set aside for prime assets for institutions that:

- have subprime assets equal to 25% or higher of Tier 1 capital, or
- have subprime portfolios experiencing rapid growth or adverse performance trends, are administered by inexperienced management, or have inadequate or weak controls.

The Bank presently does not engage in subprime lending.

#### *Premiums for Deposit Insurance*

Through the DIF, the FDIC insures our customer deposits up to prescribed limits for each depositor. The amount of FDIC assessments paid by each DIF member institution is based on its relative risk of default as measured by regulatory capital ratios and other supervisory factors. . The assessment rate currently ranges from zero to 27 cents per \$100 of domestic deposits. The FDIC may increase or decrease the assessment rate schedule on a semi-annual basis. The Federal Deposit Insurance Reform Act of 2006, or FDIRA, provides, among other things, for changes in the formula and factors to be considered by the FDIC in calculating the FDIC reserve ratio, assessments and dividends, and a one-time aggregate assessment credit for depository institutions in existence on December 31, 1996 (or their successors) which paid assessments to recapitalize the insurance funds after the banking crises of the late 1980s and early 1990s. The FDIC issued final regulations, effective January 1, 2007, implementing the provisions of FDIRA. The Bank expects to receive a one-time assessment credit that is expected to exceed any increase in assessments by the FDIC in 2007.

All FDIC-insured depository institutions must pay an annual assessment to provide funds for the payment of interest on bonds issued by the Financing Corporation, a federal corporation chartered under the authority of the



Federal Housing Finance Board. The bonds, commonly referred to as FICO bonds, were issued to capitalize the Federal Savings and Loan Insurance Corporation. The FDIC established the FICO assessment rates effective for the fourth quarter of fiscal 2006 at approximately 1.24 cents for each \$100 of assessable deposits. The FICO assessments are adjusted quarterly to reflect changes in the assessment bases of the FDIC's insurance funds and do not vary depending on a depository institution's capitalization or supervisory evaluations.

#### *Federal Home Loan Bank System*

- We are a member of the Federal Home Loan Bank of San Francisco, or FHLB-SF. Among other benefits, each Federal Home Loan Bank, or FHLB, serves as a reserve or central bank for its members within its assigned region. The FHLB makes available loans or advances to its members in compliance with the policies and procedures established by the board of directors of the individual FHLB. As an FHLB member, we are required to own a certain amount of capital stock in the FHLB.

At December 31, 2006, the Bank was in compliance with the FHLB's stock ownership requirement and our investment in FHLB capital stock totaled \$3,683,000.

#### *Interstate Banking and Branching*

Subject to certain size limitations under the Riegle-Neal Interstate Banking Act, banks have the ability to acquire or merge with banks in other states; and, subject to certain state restrictions, banks may also acquire or establish new branches outside their home state. Interstate branches are subject to certain laws of the states in which they are located. The Bank presently has not engaged in any interstate banking activity.

#### *Securities Registration*

The Bank's securities are registered with the FDIC under the Exchange Act as adopted by the FDIC. As such, the Bank is subject to the information, proxy solicitation, insider trading, corporate governance and other requirements and restrictions of the Exchange Act.

#### *The Sarbanes-Oxley Act*

The Sarbanes-Oxley Act of 2002 addresses accounting oversight and corporate governance matters and, among other things:

- required executive certification of financial presentations;
- increased requirements for board audit committees and their members;
- enhanced disclosure of controls and procedures and internal control over financial reporting;
- enhanced controls on, and reporting of, insider trading; and
- increased penalties for financial crimes and forfeiture of executive bonuses in certain circumstances.

This legislation and its implementing regulations resulted in increased costs of compliance, including certain outside professional costs. To date, these costs have not had a material impact on the Bank.

#### *USA PATRIOT Act*

The USA PATRIOT Act of 2001 and its implementing regulations significantly expanded the anti-money laundering and financial transparency laws. Under the USA PATRIOT Act, financial institutions are required to establish and maintain anti-money laundering programs which include:

- the establishment of a customer identification program;
- the development of internal policies, procedures, and controls;

- the designation of a compliance officer;
- an ongoing employee training program; and
- an independent audit function to test the programs.

The Bank has adopted comprehensive policies and procedures to address the requirements of the USA PATRIOT Act. Material deficiencies in anti-money laundering compliance can result in public enforcement actions by the banking agencies, including the imposition of civil money penalties and supervisory restrictions on growth and expansion. Such enforcement actions could also have serious reputation consequences for the Bank.

#### *Federal Reserve System*

The FRB requires all depository institutions to maintain noninterest bearing reserves at specified levels against their transaction accounts (primarily checking, NOW “negotiable order of withdrawal” and Super NOW checking accounts) and non-personal time deposits. At December 31, 2006, we were in compliance with these requirements.

#### *Impact of Monetary Policies*

Our earnings and growth are subject to the influence of domestic and foreign economic conditions, including inflation, recession and unemployment. Our earnings are affected not only by general economic conditions but also by the monetary and fiscal policies of the United States and federal agencies, particularly the FRB. The FRB can and does implement national monetary policy, such as seeking to curb inflation and combat recession, by its open market operations in United States government securities and by its control of the discount rates applicable to borrowings by banks from the FRB. The actions of the FRB in these areas influence the growth of bank loans and leases, investments and deposits and affect the interest rates charged on loans and leases and paid on deposits. The FRB’s policies have had a significant effect on the operating results of commercial banks and are expected to continue to do so in the future. The nature and timing of any future changes in monetary policies are not predictable.

#### *Loans-to-One Borrower Limitations*

With certain limited exceptions, the maximum amount of obligations, secured or unsecured, that any borrower (including certain related entities) may owe to a California state bank at any one time may not exceed 25% of the sum of the shareholders’ equity, allowance for loan losses, capital notes and debentures of the bank. Unsecured obligations may not exceed 15% of the sum of the shareholders’ equity, allowance for loan losses, capital notes and debentures of the bank. The Bank has established internal loan limits which are lower than the legal lending limits for a California bank. At December 31, 2006, the Bank’s largest single lending relationship had a combined outstanding balance of \$20.7 million, secured predominantly by commercial real estate properties in the Bank’s lending area, and which is performing in accordance with their terms of the Bank’s loans.

#### *Extensions of Credit to Insiders and Transactions with Affiliates*

The Bank is subject to Federal Reserve Regulation O and companion California banking law limitations and conditions on loans or extensions of credit to:

- the Bank’s executive officers, directors and principal shareholders (*i.e.*, in most cases, those persons who own, control or have power to vote more than 10% of any class of voting securities);
- any company controlled by any such executive officer, director or shareholder; or
- any political or campaign committee controlled by such executive officer, director or principal shareholder.

Loans and leases extended to any of the above persons must comply with loan-to-one-borrower limits, require prior full board approval when aggregate extensions of credit to the person exceed specified amounts, must be made on substantially the same terms (including interest rates and collateral) as, and follow credit-underwriting procedures that are not less stringent than those prevailing at the time for comparable transactions with non-insiders, and must not involve more than the normal risk of repayment or present other unfavorable features. In addition, Regulation O provides that the aggregate limit on extensions of credit to all insiders of a bank as a group cannot exceed the bank's unimpaired capital and unimpaired surplus. Regulation O also prohibits a bank from paying an overdraft on an account of an executive officer or director, except pursuant to a written pre-authorized interest-bearing extension of credit plan that specifies a method of repayment or a written pre-authorized transfer of funds from another account of the officer or director at the bank. California has laws and the DFI has regulations which adopt and also apply Regulation O to the Bank.

The Bank also is subject to certain restrictions imposed by Federal Reserve Act Sections 23A and 23B and Federal Reserve Regulation W on any extensions of credit to, or the issuance of a guarantee or letter of credit on behalf of, any affiliates, the purchase of, or investments in, stock or other securities thereof, the taking of such securities as collateral for loans, and the purchase of assets of any affiliates. Such restrictions prevent any affiliates from borrowing from the Bank unless the loans are secured by marketable obligations of designated amounts. Further, such secured loans and investments to or in any affiliate are limited, individually, to 10.0% of the Bank's capital and surplus (as defined by federal regulations), and such secured loans and investments are limited, in the aggregate, to 20.0% of the Bank's capital and surplus. A financial subsidiary is considered an affiliate subject to these restrictions whereas other nonbanking subsidiaries are not considered affiliates. Additional restrictions on transactions with affiliates may be imposed on the Bank under the FDI Act prompt corrective action provisions and the supervisory authority of the federal and state banking agencies.

#### *Consumer Protection Laws and Regulations*

Examination and enforcement by the state and federal banking agencies for non-compliance with consumer protection laws and their implementing regulations have become more intense. We are subject to many consumer statutes and regulations, some of which are discussed below. The Bank is also subject to federal and state laws prohibiting unfair or fraudulent business practices, untrue or misleading advertising and unfair competition.

The Home Ownership and Equity Protection Act of 1994, or HOEPA, requires extra disclosures and consumer protections to borrowers for certain lending practices. The term "predatory lending," much like the terms "safety and soundness" and "unfair and deceptive practices," is far-reaching and covers a potentially broad range of behavior. As such, it does not lend itself to a concise or a comprehensive definition. Typically, however, predatory lending involves at least one, and perhaps all three, of the following elements:

- making unaffordable loans based on the assets of the borrower rather than on the borrower's
- ability to repay an obligation ("asset-based lending");
- inducing a borrower to refinance a loan repeatedly in order to charge high points and fees each time the loan is refinanced ("loan flipping"); and/or
- engaging in fraud or deception to conceal the true nature of the loan obligation from an unsuspecting or unsophisticated borrower.

Regulations and banking agency guidelines aimed at curbing predatory lending significantly widen the pool of high-cost home-secured loans covered by HOEPA. In addition, the regulations bar certain refinances within a year with another loan subject to HOEPA by the same lender or loan servicer. Lenders also will be presumed to have violated the law—which says loans should not be made to people unable to repay them—unless they document that the borrower has the ability to repay. Lenders that violate the rules face cancellation of loans and penalties equal to the finance charges paid. The Bank does not expect these rules and potential state action in this area to have a material impact on our financial condition or results of operations.

Privacy policies are required by federal banking regulations which limit the ability of banks and other financial institutions to disclose nonpublic information about consumers to nonaffiliated third parties. Pursuant to those rules, financial institutions must provide:

- initial notices to customers about their privacy policies, describing the conditions under which they may disclose nonpublic personal information to nonaffiliated third parties and affiliates;
- annual notices of their privacy policies to current customers; and
- a reasonable method for customers to “opt out” of disclosures to nonaffiliated third parties.

These privacy protections affect how consumer information is transmitted through diversified financial companies and conveyed to outside vendors. In addition, state laws may impose more restrictive limitations on the ability of financial institutions to disclose such information. California has adopted such a privacy law that, among other things, generally provides that customers must “opt in” before information may be disclosed to certain nonaffiliated third parties.

The Fair Credit Reporting Act, as amended by the Fair and Accurate Credit Transactions Act, or the FACT Act, requires financial firms to help deter identity theft, including developing appropriate fraud response programs, and gives consumers more control of their credit data. It also reauthorizes a federal ban on state laws that interfere with corporate credit granting and marketing practices. In connection with FACT Act, the federal financial institution regulatory agencies proposed rules that would prohibit an institution from using certain information about a consumer it received from an affiliate to make a solicitation to the consumer, unless the consumer has been notified and given a chance to opt out of such solicitations. A consumer’s election to opt out would be applicable for at least five years. The agencies have also proposed guidelines required by the FACT Act for financial institutions and creditors which require financial institutions to identify patterns, practices and specific forms of activity, known as “Red Flags,” that indicate the possible existence of identity theft and require financial institutions to establish reasonable policies and procedures for implementing these guidelines.

The Check Clearing for the 21st Century Act, or Check 21, facilitates check truncation and electronic check exchange by authorizing a new negotiable instrument called a “substitute check,” which is the legal equivalent of an original check. Check 21 does not require banks to create substitute checks or accept checks electronically; however, it does require banks to accept a legally equivalent substitute check in place of an original. In addition to its issuance of regulations governing substitute checks, the Federal Reserve has issued final rules governing the treatment of remotely created checks (sometimes referred to as “demand drafts”) and electronic check conversion transactions (involving checks that are converted to electronic transactions by merchants and other payees).

The Community Reinvestment Act, or CRA, is intended to encourage insured depository institutions, while operating safely and soundly, to help meet the credit needs of their communities. The CRA specifically directs the federal regulatory agencies, in examining insured depository institutions, to assess a bank’s record of helping meet the credit needs of its entire community, including low- and moderate-income neighborhoods, consistent with safe and sound banking practices. The CRA further requires the agencies to take a financial institution’s record of meeting its community credit needs into account when evaluating applications for, among other things, domestic branches, mergers or acquisitions, or holding company formations. The agencies use the CRA assessment factors in order to provide a rating to the financial institution. The ratings range from a high of “outstanding” to a low of “substantial noncompliance.” In its last examination for CRA compliance, as of November 15, 2005 we were rated “Satisfactory.”

The Equal Credit Opportunity Act, or ECOA, generally prohibits discrimination in any credit transaction, whether for consumer or business purposes, on the basis of race, color, religion, national origin, sex, marital status, age (except in limited circumstances), receipt of income from public assistance programs, or good faith exercise of any rights under the Consumer Credit Protection Act.

The Truth in Lending Act, or TILA, is designed to ensure that credit terms are disclosed in a meaningful way so that consumers may compare credit terms more readily and knowledgeably. As a result of the TILA, all creditors must use the same credit terminology to express rates and payments, including the annual percentage rate, the finance charge, the amount financed, the total of payments and the payment schedule, among other things.

The Fair Housing Act, or FH Act, regulates many practices, including making it unlawful for any lender to discriminate in its housing-related lending activities against any person because of race, color, religion, national origin, sex, handicap or familial status. A number of lending practices have been found by the courts to be, or may be considered, illegal under the FH Act, including some that are not specifically mentioned in the FH Act itself.

The Home Mortgage Disclosure Act, or HMDA, grew out of public concern over credit shortages in certain urban neighborhoods and provides public information that will help show whether financial institutions are serving the housing credit needs of the neighborhoods and communities in which they are located. The HMDA also includes a “fair lending” aspect that requires the collection and disclosure of data about applicant and borrower characteristics as a way of identifying possible discriminatory lending patterns and enforcing anti-discrimination statutes. The Federal Reserve amended regulations issued under HMDA to require the reporting of certain pricing data with respect to higher priced mortgage loans for review by the federal banking agencies from a fair lending perspective. We do not expect the HMDA data reported by the Bank to raise material issues regarding its compliance with the fair lending laws.

Finally, the Real Estate Settlement Procedures Act, or RESPA, requires lenders to provide borrowers with disclosures regarding the nature and cost of real estate settlements. Also, RESPA prohibits certain abusive practices, such as kickbacks, and places limitations on the amount of escrow accounts. Penalties under the above laws may include fines, reimbursements and other penalties.

The National Flood Insurance Act, or NFIA, requires homes in flood-prone areas with mortgages from a federally regulated lender to have flood insurance. Hurricane Katrina focused awareness on this requirement. Lenders are required to provide notice to borrowers of special flood hazard areas and require such coverage before making, increasing, extending or renewing such loans. Financial institutions which demonstrate a pattern and practice of lax compliance are subject to the issuance of cease and desist orders and the imposition of per loan civil money penalties, up to a maximum fine which currently is \$125,000. Fine payments are remitted to the Federal Emergency Management Agency for deposit into the National Flood Mitigation Fund.

Due to heightened regulatory concern related to compliance with HOEPA, privacy laws and regulations, FACT, Check 21, CRA, TILA, FH Act, ECOA, HMDA, RESPA and NFIA generally, we may incur additional compliance costs or be required to expend additional funds for CRA investments.

#### *Recent and Proposed Legislation*

Our operations are subject to extensive regulation by federal, state and local governmental authorities and are subject to various laws and judicial and administrative decisions imposing requirements and restrictions on part or all of their respective operations. Because our business is highly regulated, the laws, rules and regulations applicable to us are subject to regular modification and change.

From time to time, federal and state legislation is enacted which may have the effect of materially increasing the cost of doing business, limiting or expanding permissible activities, or affecting the competitive balance between banks and other financial service providers. Proposals to change the laws and regulations governing the operations and taxation of banks and other financial institutions are frequently made in Congress, in the California legislature and before various bank regulatory agencies. The Bank cannot predict whether or when potential 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. In addition, the outcome of any investigations initiated by state or federal authorities or litigation may result in necessary changes in our operations, additional regulation and increased compliance costs.

*Financial Services Modernization Legislation.* On November 12, 1999 the Gramm-Leach-Bliley Act of 1999, also known as the Financial Services Modernization Act, was signed into law. The Financial Services Modernization Act is intended to modernize the banking industry by removing barriers to affiliation among banks, insurance companies, the securities industry and other financial service providers. It provides financial organizations with the flexibility of structuring such affiliations through a holding company structure or through a financial subsidiary of a bank, subject to certain limitations. The Financial Services Modernization Act establishes a new type of bank holding company known as a financial holding company that may engage in an expanded list of activities that are financial in nature, which include securities and insurance brokerage, securities underwriting, insurance underwriting and merchant banking.

The Financial Services Modernization Act also sets forth a system of functional regulation that makes the FRB the “umbrella supervisor” for holding companies, while providing for the supervision of the holding company’s subsidiaries by other federal and state agencies. A bank holding company may not become a financial holding company if any of its subsidiary financial institutions are not well-capitalized or well-managed. Further, each bank subsidiary of the holding company must have received at least a satisfactory CRA rating. The Financial Services Modernization Act also expands the types of financial activities a national bank may conduct through a financial subsidiary, addresses state regulation of insurance, provides privacy protection for nonpublic customer information of financial institutions, modernizes the FHLB system and makes miscellaneous regulatory improvements. The FRB and the Secretary of the Treasury must coordinate their supervision regarding approval of new financial activities to be conducted through a financial holding company or through a financial subsidiary of a bank. While the provisions of the Financial Services Modernization Act regarding activities that may be conducted through a financial subsidiary directly apply only to national banks, those provisions indirectly apply to state-chartered banks.

In addition, we are subject to other provisions of the Financial Services Modernization Act, including those relating to CRA, privacy and safe-guarding confidential customer information, regardless of whether we elect to establish a holding company and become a financial holding company or to conduct activities through a financial subsidiary.

We do not believe that the Financial Services Modernization Act will have a material adverse effect on our operations in the near term. However, to the extent that it permits banks, securities firms and insurance companies to affiliate, the financial services industry will continue to experience further consolidation. The Financial Services Modernization Act is intended to grant to community banks certain powers as a matter of right that larger institutions have accumulated on an ad hoc basis. Nevertheless, this act may have the result of increasing the amount of competition that we face from larger institutions and other types of companies offering financial products, many of which may have substantially more financial resources than us.

*Safety and Soundness Standards.* The Federal Deposit Insurance Corporation Improvement Act, or FDICIA, imposes certain specific restrictions on transactions and requires federal banking regulators to adopt overall safety and soundness standards for depository institutions related to internal control, loan underwriting and documentation and asset growth. Among other things, FDICIA limits the interest rates paid on deposits by undercapitalized institutions, restricts the use of brokered deposits, limits the aggregate extensions of credit by a depository institution to an executive officer, director, principal shareholder or related interest and reduces deposit insurance coverage for deposits offered by undercapitalized institutions for deposits by certain employee benefits accounts. The federal banking agencies may require an institution to submit to an acceptable compliance plan as well as have the flexibility to pursue other more appropriate or effective courses of action given the specific circumstances and severity of an institution’s noncompliance with one or more standards.



*California Financial Information Privacy Act.* The California Financial Information Privacy Act, or CFIPA, which was enacted in August 2003, imposes stricter limits on the use of consumers' nonpublic personal information by financial institutions beyond those imposed by the Financial Services Modernization Legislation. CFIPA applies to any financial institution doing business in California, but only with respect to the individual consumers of the institution that reside in California.

Under CFIPA, and subject to certain specified exceptions, a financial institution must now obtain a consumer's written consent before disclosing the consumer's nonpublic personal information to any nonaffiliated third party. Before releasing a consumer's nonpublic personal information to an affiliate, the financial institution must give the consumer the opportunity to direct that his or her information not be disclosed. This "opt-out" requirement also applies to information a financial institution discloses in connection with (1) certain joint marketing agreements with other financial institutions and (2) agreements with "affinity partners" in whose name the financial institution issues credit cards or other financial products. A financial institution that meets certain conditions may, however, share nonpublic personal information with its wholly owned financial institution subsidiaries or sister companies engaged in the same line of business.

CFIPA provides a statutory form of "opt-out" notice that a financial institution may use to offer consumers the opportunity to communicate their privacy preferences. A financial institution may satisfy CFIPA's notice requirements by sending out this form annually. Alternatively, a financial institution may use its own form, subject to specific requirements and limitations.

Since these provisions are more restrictive than the privacy provisions of the Financial Services Modernization Act, CFIPA would require us to adopt new policies, procedures and disclosure documentation. The cost of complying with this legislation is not predictable at this time.

## **Employees**

As of December 31, 2006, the Bank had a total of 132 full-time equivalent employees. None of the employees are represented by a union or collective bargaining group. The management of the Bank believes that their employee relations are satisfactory.

## **Available Information**

The Bank also maintains an internet website at [www.preferredbank.com](http://www.preferredbank.com). The Bank makes its website content available for information purposes only. It should not be relied upon for investment purposes.

We are subject to the reporting and other requirements of the Securities Exchange Act of 1934, as amended. In accordance with Sections 12, 13 and 14 of the Exchange Act and as a bank that is not a member of the Federal Reserve System, we file certain reports, proxy materials, information statements and other information with the FDIC, copies of which can be inspected and copied at the public reference facilities maintained by the FDIC, at the Public Reference Section, Room F-6043, 550 17th Street, N.W., Washington, DC 20429. Requests for copies may be made by telephone at (202) 898-8913 or by fax at (202) 898-3909. [Form 3, 4 and 5 filed electronically with FDIC, at the FDIC's website at <http://www.fdic.gov>.]

## **ITEM 1A. RISK FACTORS**

### **Risk Factors That May Affect Future Results**

In addition to the other information on the risks we face and our management of risk contained in this annual report or in our other filings, the following are significant risks which may affect our business, financial condition, operations and prospects and the value and price of our common stock could decline. The risks identified below are not intended to be a comprehensive list of all risks we face and additional risks that we may currently view as not material may also impair our business operations and results.



**Changes in economic conditions, and in particular a prolonged economic slowdown in the State of California, could hurt our business materially.**

Our business is directly affected by factors such as changes in 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. We are particularly susceptible to conditions and changes affecting the State of California and Southern California in view of the concentration of our operations and the collateral securing our loan portfolio in Southern California. The negative effects of weak national and international economic recoveries, the threat of terrorism and the uncertainty associated with the impact of the war in Iraq on California's economy were exacerbated by the state's budget crisis and the recent hike in energy prices, the recall of its governor and wildfires in Southern California. Deterioration in economic conditions, in California and Southern California in particular, could result in the following consequences, any of which could have a material adverse effect on our business, financial condition, results of operations and cash flows:

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

In addition, because we make loans to small to medium-sized businesses, many of our customers may be particularly susceptible to economic slowdowns or recessions and may be unable to make scheduled principal or interest payments during these periods.

**Most of our loans are secured by real estate, and a downturn in the California real estate market could have a material adverse effect on our business, financial condition, results of operations and cash flows.**

A downturn in the California real estate market could hurt our business because most of our loans are secured by real estate located in California. As of December 31, 2006, approximately 71% of the book value of our loan portfolio consisted of loans collateralized by various types of California real estate. Real estate values and real estate markets are generally affected by changes in national, regional or local economic conditions, fluctuations in interest rates and the availability of loans to potential purchasers, changes in tax laws and other laws, regulations and policies and acts of nature. In addition, real estate values in California could be affected by, among other things, earthquakes and national disasters particular to the state. If real estate prices decline, particularly in California, the value of real estate collateral securing our loans could be significantly reduced. As a result, we may experience greater charge-offs and, similarly, our ability to recover on defaulted loans by foreclosing and selling the real estate collateral would then be diminished and we would be more likely to suffer losses on defaulted loans. If there is a significant decline in real estate values, especially in California, the collateral for our loans will provide less security.

**We rely heavily on our senior management team and other key employees, the loss of whom could materially and adversely affect our business.**

Our success depends heavily on the abilities and continued service of our executive officers, especially Li Yu, our founder, Chairman, President and Chief Executive Officer, and Walter Duchanin, our Executive Vice President. These two individuals, who have worked together since our founding, are integral to implementing our

business plan. We currently do not have employment agreements or non-competition agreements with Messrs. Yu or Duchanin. Accordingly, members of our senior management team are not contractually prohibited from leaving or joining one of our competitors. If we lose the services of any of our executive officers, especially Mr. Yu or Mr. Duchanin, our business, financial condition, results of operations and cash flows may be adversely affected. Furthermore, attracting suitable replacements may be difficult and may require significant management time and resources.

We also rely to a significant degree on the abilities and continued service of our private banking, loan origination, underwriting, administrative, marketing and technical personnel. Competition for qualified employees and personnel in the banking industry is intense and there are a limited number of qualified persons with knowledge of, and experience in, the California community banking industry. The process of recruiting personnel with the combination of skills and attributes required to carry out our strategies is often lengthy. If we fail to attract and retain qualified management personnel and the necessary deposit generation, loan origination, underwriting, administrative, finance marketing and technical personnel, our business, financial condition, results of operations and cash flows may be materially adversely affected.

**A natural disaster or recurring energy shortage, especially in California, could harm our business.**

Historically, Southern California has been vulnerable to natural disasters. Therefore, we are susceptible to the risks of natural disasters, such as earthquakes, wildfires, floods and mudslides. Natural disasters could harm our operations directly through interference with communications, as well as through the destruction of facilities and our operational, financial and management information systems. Uninsured or underinsured disasters may reduce a borrower's ability to repay mortgage loans. Disasters may also reduce the value of the real estate securing our loans, impairing our ability to recover on defaulted loans. Southern California has also experienced energy shortages which, if they recur, could impair the value of the real estate in those areas affected. The occurrence of natural disasters or energy shortages in Southern California could have a material adverse effect on our business, financial condition, results of operations and cash flows.

**Our business is subject to interest rate risk and variations in interest rates may negatively affect our financial performance.**

Market interest rates are affected by many factors that are beyond our control and are hard to predict, including inflation, recession, performance of the stock markets, a rise in unemployment, tightening money supply, exchange rates, monetary and other policies of various governmental and regulatory agencies, domestic and international disorder and instability in domestic and foreign financial markets.

Changes in the interest rate environment may reduce our profits. Changes in interest rates will influence not only the interest we receive on our loans and investment securities and the amount of interest we pay on deposits, it will also affect our ability to originate loans and obtain deposits and our costs in doing so. Rising interest rates, generally, are associated with a lower volume of loan originations, while lower interest rates are usually associated with higher loan originations.

We expect that we will continue to realize a substantial portion of our income from the differential or "spread" between the interest earned on loans, securities and other interest-earning assets, and interest paid on deposits, borrowings and other interest-bearing liabilities. Because interest rates are based on the maturity, repricing and other characteristics of an instrument, conditions that trigger changes in interest rates do not produce equivalent changes in interest income earned on our interest-earning assets and interest expense paid on our interest-bearing liabilities. Accordingly, fluctuations in interest rates could adversely affect our interest rate spread and, in turn, our profitability.

In addition, an increase in the general level of interest rates may adversely affect the ability of some borrowers to pay the interest on and principal of their obligations, which could reduce our cash flows and harm our asset quality. In rising interest rate environments, loan repayment rates may decline and in falling interest rate environments, loan repayment rates may increase.

**We face strong competition from financial services companies and other companies that offer banking services, and our failure to compete effectively with these companies could have a material adverse effect on our business, financial condition, results of operations and cash flows.**

We conduct our operations primarily in California. The banking and financial services businesses in California are highly competitive and increased competition within California may result in reduced loan originations and deposits. Ultimately, we may not be able to compete successfully against current and future competitors. Many competitors offer the types of loans and banking services that we offer in our service areas. These competitors include national banks, regional banks and other community banks. We also face competition from many other types of financial institutions, including saving and loan associations, finance companies, brokerage firms, insurance companies, credit union, mortgage banks and other financial intermediaries. In particular, our competitors include financial institutions whose greater resources may afford them a marketplace advantage by enabling them to maintain numerous banking locations and mount extensive promotional and advertising campaigns. Areas of competition include interest rates for loans and deposits, efforts to obtain loan and deposit customers and a range in quality of products and services provided, including new technology-driven products and services. Competitive conditions may intensify as continued merger activity in the financial services industry produces larger, better-capitalized and more geographically diverse companies. Additionally, banks and other financial institutions with larger capitalization and financial intermediaries not subject to bank regulatory restrictions may have larger lending limits which would allow them to serve the credit needs of larger customers. These institutions, particularly to the extent they are more diversified than we are, may be able to offer the same loan products and services we offer at more competitive rates and prices.

We also face competition from out-of-state financial intermediaries that have opened loan production offices or that solicit deposits in our market areas. If we are unable to attract and retain banking customers, we may be unable to continue our loan growth and level of deposits, and our business, financial condition, results of operations and cash flows may be materially adversely affected.

**If our underwriting practices are not effective, we may suffer losses in our loan portfolio and our results of operations may be harmed.**

We seek to mitigate the risks inherent in our loan portfolio by adhering to specific underwriting practices. Depending on the type of loan, these practices include analysis of a borrower's prior credit history, financial statements, tax returns and cash flow projections, valuation of collateral based on reports of independent appraisers and verification of liquid assets. Although we believe that our underwriting criteria are appropriate for the types of loans we make, we cannot assure you that they will be effective in mitigating all risks. If our underwriting criteria prove to be ineffective, we may incur losses in our loan portfolio, and these losses may exceed the amounts set aside as reserves in our allowance for loan losses.

**If our allowance for loan and lease losses is inadequate to cover actual losses, our financial results would be harmed.**

A significant source of risk arises from the possibility that we could sustain losses because borrowers, guarantors and related parties may fail to perform in accordance with the terms of their loans and leases. The underwriting and credit monitoring policies and procedures that we have adopted to address this risk may not prevent unexpected losses that could have a material adverse effect on our business, financial condition, results of operations and cash flows. Unexpected losses may arise for a wide variety of reasons, many of which are beyond our ability to predict, influence or control. Some of these reasons could include a prolonged economic downturn in the State of California, a decline in the California real estate market, changes in the interest rate environment, adverse economic conditions in Asia and natural disasters.

Like all financial institutions, we maintain an allowance for loan and lease losses to provide for loan and lease defaults and non-performance. Our allowance for loan and lease losses may not be adequate to cover actual

loan and lease losses, and future provisions for loan and lease losses could materially and adversely affect our business, financial condition, results of operations and cash flows. Our allowance for loan and lease losses reflects our best estimate of the losses inherent in the existing loan and lease portfolio at the relevant balance sheet date and is based on management's evaluation of the collectibility of the loan and lease portfolio, which evaluation is based on historical loss experience and other significant factors. The determination of an appropriate level of loan and lease loss allowance is an inherently difficult process and is based on numerous assumptions. The amount of future losses is susceptible to changes in economic, operating and other conditions, including changes in interest rates, that may be beyond our control and these losses may exceed current estimates. While we believe that our allowance for loan and lease losses is adequate to cover current losses, we cannot assure you that we will not increase the allowance for loan and lease losses further or that regulators will not require us to increase our allowance. Either of these occurrences could materially adversely affect our business, financial condition and results of operations would not affect cash flow directly.

**If the risks inherent in construction lending are realized, our net income could be adversely affected.**

At December 31, 2006, our construction loans were \$271.0 million, or 27% of our total loans and leases held, and the average loan size of our construction loans was \$2.7 million. The risks inherent in construction lending include, among other things, the possibility that contractors may fail to complete, or fail to complete on a timely basis, construction of the relevant properties; substantial cost overruns in excess of original estimates and financing; market deterioration during construction; and a lack of permanent take-out financing. Loans secured by these properties also involve additional risk because the properties have no operating histories. In these loans, funds are advanced upon the security of the project under construction, which is of uncertain value prior to completion of construction, and the estimated operating cash flow to be generated by the completed project. The borrowers' ability to repay their obligations to us and the value of our security interest in the collateral will be materially adversely affected if the projects do not generate sufficient cash flow by being either sold or leased.

**If the appraised value of our real property collateral is greater than the proceeds we realize from a sale or foreclosure of the property, we may suffer a loss in our loan portfolio.**

In considering whether to make a loan on or secured by real property, we require an appraisal on such property. However, an appraisal is only an estimate of the value of the property at the time the appraisal is made. If the appraisal does not reflect the amount that may be obtained upon any sale or foreclosure of the property, we may not realize an amount equal to the indebtedness secured by the property and we may suffer a loss in our loan portfolio.

**Adverse economic conditions in Asia could impact our business adversely.**

We estimate that at December 31, 2006, approximately 66% of our non-governmental deposits and 22% of our loans were with customers from the Chinese-American market. We believe these customers maintain significant ties to many Asian countries and, therefore, could be affected by economic and other conditions in those countries. We cannot predict the behavior of the Asian economies. U.S. economic policies, the economic policies of countries in Asia, domestic unrest and/or military tensions, crises in leadership succession, currency devaluations, and an unfavorable global economic condition may among other things adversely impact the Asian economies. We generally do not loan to customers or take collateral located outside of Southern California. However, if Asian economic conditions should deteriorate, we could experience an outflow of deposits by our Chinese-American customers. In addition, adverse economic conditions could prevent or delay these customers from meeting their obligations to us. This may adversely impact the recoverability of investments with or loans made to these customers. Adverse economic conditions may also negatively impact asset values and the profitability and liquidity of companies operating in Asia, which will also impact the Bank's liquidity.

At December 31, 2006, approximately \$86.1 million, or 9%, of our loan portfolio consisted of loans made to finance international trade activities. Changes in monetary policy, including changes in interest rates,

governmental regulation of international trade activities, currency valuation, price competition, competition from other financial institutions and general economic and political conditions could negatively impact the amount of goods imported to and exported from the United States, the ability of borrowers to repay loans made by us, and the number and extent of importers' and exporters' need for our trade finance activities. It is possible that if the U.S. dollar weakens against other foreign currencies, the cost of imported goods will increase, which could have an adverse impact on some of our customers who import goods for resale in the United States. Such factors could have a material adverse effect on our business, financial condition, results of operations and cash flows.

**If we cannot attract deposits, our growth may be inhibited.**

We plan to increase significantly the level of our assets, including our loan portfolio. Our ability to increase our asset base depends in large part on our ability to attract additional deposits at attractive rates. We intend to seek additional deposits by continuing to establish and strengthening our personal relationships with our customers and by offering deposit products that are competitive with those offered by other financial institutions in our markets. We cannot assure you that these efforts will be successful. Our inability to attract additional deposits at competitive rates could have a material adverse effect on our business, financial condition, results of operations and cash flows.

**We rely primarily on large certificates of deposits to fund our operations, and the potential volatility of such deposits and the unavailability of any such funds in the future could adversely impact our growth strategy and prospects.**

We primarily rely on deposits, in particular certificates of deposit of \$100,000 or more, or Jumbo CDs, to fund our operations. At December 31, 2006, we held \$619.1 million of Jumbo CDs, representing 53% of total deposits. These deposits are considered by the banking industry to be volatile and could be subject to withdrawal. Withdrawal of a material amount of such deposits would adversely impact our liquidity, profitability, business, financial condition, results of operations and cash flows.

**Our inability to raise additional capital when needed or on favorable terms could inhibit our growth and could harm our operations.**

To the extent that our deposits and total assets continue to grow, we may need to increase our capital in order to maintain our compliance with regulatory capital requirements. We may also need additional capital to fund growth in our loan portfolio or in the event we are unable to attract sufficient deposits in order to fund our growth. We cannot predict the timing and amount of our future capital requirements. If our capital needs exceed our earnings, we may seek funding through the capital markets; however, we may not be able to obtain capital when we need to or when it would be advantageous for us to do so. Failure to raise capital when needed could limit or eliminate our ability to grow, or in extreme instances, materially adversely affect our operations. Moreover, even if capital is available, it may be upon terms that are not favorable to existing common shareholders and could dilute their interest.

**Our inability to manage our growth could harm our business.**

Our financial performance and profitability depend on our ability to execute our corporate growth strategy. We anticipate that our asset size and deposit base will continue to grow over time, perhaps significantly. In addition to seeking deposit and loan and lease growth in our existing markets, we intend to pursue expansion opportunities through strategically placed new branches, or by acquiring branch locations that we find attractive. Continued growth, however, may present operating and other integration problems. Our growth plans may place a strain on our administrative, operational, staffing and financial resources and increase demands on our systems and controls. To manage the expected growth of our operations and personnel, we will be required to, among other things:

- improve existing and implement new transaction processing, operational and financial systems, procedures and controls;

- maintain effective underwriting guidelines; and
- expand our employee base and train and manage this growing employee base.

The following risks, associated with our growth, internally or by acquisition, could have a material adverse effect on our business, financial condition, results of operations and cash flows:

- the potential disruption of our ongoing business
- our inability to continue to upgrade or maintain effective operating and financial control systems
- our inability to recruit and hire necessary personnel or to integrate successfully new personnel into our operations
- our inability to integrate successfully the operations of [acquired businesses] or to manage our growth effectively
- [the inability of our management to maximize our financial and strategic position after acquisitions by successful implementation of uniform product offerings and the incorporation of uniform technology into our produce offerings, services and control systems]
- 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
- our inability to respond promptly or adequately to the emergence of unexpected expansion difficulties

We cannot assure you that we will be successful in overcoming these risks or any other problems encountered in connection with implementing our internal growth strategies. If we are unable to manage our growth effectively, our business, financial condition, results of operations and cash flows could be materially adversely affected.

**We rely on communications, information, operating and financial control systems technology from third-party service providers, and we may suffer an interruption in or break of those systems.**

We rely on communications, information, operating and financial control systems technology from third-party service providers, and we may suffer an interruption in or break of those systems that may result in lost business and we may not be able to obtain substitute providers on terms that are as favorable if our relationships with our existing service providers are interrupted. We rely heavily on third-party service providers for much of our communications, information, operating and financial control systems technology, including customer relationship management, general ledger, deposit, servicing and loan origination systems. Any failure or interruption or breach in security of these systems could result in failures or interruptions in our customer relationship management, general ledger, deposit, servicing and/or loan origination systems. We cannot assure you that such failures or interruptions will not occur or, if they do occur, that they will be adequately addressed by us or the third parties on which we rely. The occurrence of any failures or interruptions could have a material adverse effect on our business, financial condition, results of operations and cash flows. If any of our third-party service providers experience financial, operational or technological difficulties, or if there is any other disruption in our relationships with them, we may be required to locate alternative sources of such services, and we cannot assure you that we could negotiate terms that are as favorable to us, or could obtain services with similar functionality as found in our existing systems without the need to expend substantial resources, if at all. Any of these circumstances could have a material adverse effect on our business, financial condition, results of operations and cash flows.

**The U.S. government's monetary policies or changes in those policies could have a major effect on our operating results, and we cannot predict what those policies will be or any changes in such policies or the effect of such policies on us.**

Our earnings will be affected by domestic economic conditions and the monetary and fiscal policies of the U.S. government and its agencies. The monetary policies of the Federal Reserve Bank, or the FRB, have had, and



will continue to have, an important effect on the operating results of commercial banks and other financial institutions through its power to implement national monetary policy in order, among other things, to curb inflation or combat a recession.

The monetary policies of the FRB, effected principally through open market operations and regulation of the discount rate and reserve requirements, have had major effects upon the levels of bank loans, investments and deposits. For example, in 2004-2006, seventeen increases in the Fed Funds rate by the Federal Open Market Committee placed tremendous pressure on the profitability of many financial institutions because of the resulting contraction of net interest margins. It is not possible to predict the nature or effect of future changes in monetary and fiscal policies.

**We are subject to extensive government regulation which may hamper our ability to increase our assets and earnings and could result in a decrease in the value of your shares.**

Our operations are subject to extensive regulation by federal, state and local governmental authorities and are subject to various laws and judicial and administrative decisions imposing requirements and restrictions on part or all of our operations. Because our business is highly regulated, the laws, rules and regulations and supervisory guidance and policies applicable to us are subject to regular modification and change, which may have the effect of increasing or decreasing the cost of doing business, modifying permissible activities or enhancing the competitive position of other financial institutions. These laws are primarily intended for the protection of consumers, depositors and the deposit insurance funds and not for the protection of shareholders of bank holding companies or banks. Perennially, various laws, rules and regulations are proposed which, if adopted, could impact our operations by making compliance much more difficult or expensive, restricting our ability to originate or sell loans or further restricting the amount of interest or other charges or fees earned on loans or other products. . We cannot assure you that these proposed laws, rules and regulations or any other laws, rules or regulations will not be adopted in the future, which could make compliance much more difficult or expensive, restrict our ability to originate loans, further limit or restrict the amount of commissions, interest or other charges earned on loans originated by us or otherwise adversely affect our business, financial condition, results of operations or cash flows.

**We are exposed to risk of environmental liability with respect to properties to which we take title.**

In the course of our business, we may foreclose on and take title to properties securing our loans. If hazardous substances were discovered on any of the properties, we may be held liable to governmental entities or to third parties for property damage, personal injury, investigation and clean-up costs incurred by these parties in connection with environmental contamination or may be required to investigate or clean up hazardous or toxic substances or chemical releases at a property. Many environmental laws can impose liability regardless of whether we knew of or were responsible for the contamination. In addition, if we arrange for the disposal of hazardous or toxic substances at another site, we may be liable for the costs of cleaning up and removing those substances from the site, even if we neither own nor operate the disposal site. Environmental laws may require us to incur substantial expenses and may materially limit use of properties we acquire through foreclosure, reduce their value or limit our ability to sell them in the event of a default on the loans they secure. In addition, future laws or more stringent interpretations or enforcement policies with respect to existing laws may increase our exposure to environmental liability.

**Negative publicity could damage our reputation.**

Reputation risk, or the risk to our earnings and capital from negative publicity or public opinion, is inherent in our business. Negative publicity or public opinion could adversely affect our ability to keep and attract customers and expose us to adverse legal and regulatory consequences. Negative public opinion could result from our actual or perceived conduct in any number of activities, including lending practices, corporate

governance, regulatory compliance, mergers and acquisitions, and disclosure, sharing or inadequate protection of customer information, and from actions taken by government regulators and community organizations in response to that conduct.

**The threat of terrorism has depressed the economy generally and could worsen, particularly if there are further terrorist events.**

The terrorist attacks and international conflicts of recent years have resulted in continued uncertainty regarding the economic outlook of the United States. The possibility of further terrorist attacks, as well as continued terrorist threats, may prolong the depth and length of this economic uncertainty. Future terrorist acts and responses to such activities could adversely affect us in a number of ways, including an increase in delinquencies, bankruptcies or defaults that could result in a higher level of non-performing assets, net charge-offs and provision for loan losses.

### **Executive Officers of the Bank**

The following table sets forth our executive officers, their positions and their ages. Each officer is appointed by our Board of Directors and serves at their pleasure.

<u>Name</u>	<u>Age (1)</u>	<u>Position with Bank</u>
Li Yu .....	[66]	Chairman of the Board, President and Chief Executive Officer
Walt Duchanin .....	[53]	Executive Vice President and Chief Credit Officer
Edward J. Czajka .....	[42]	Senior Vice President and Chief Financial Officer
Nick Pi .....	[46]	Executive Vice President and Group Manager

(1) As of March 29, 2007

**Li Yu** has been our President and Chief Executive Officer since 1993. From December 1991 to the present, he has served as Chairman of our Board of Directors. From 1987 to 1991, he was involved in several privately held companies of which he was the owner. From 1982 to 1987, he served as Chairman of the Board of California Pacific National Bank, which became a part of Bank of America. Mr. Yu received a Masters of Business Administration, or MBA, from the University of California, Los Angeles. He was also the past President of the National Association of Chinese American Bankers, and is currently a member of the Board of Visitors of UCLA’s Anderson Graduate School of Management.

**Edward J. Czajka** has been Senior Vice president and Chief Financial Officer since 2006. Before joining Preferred Bank, Mr. Czajka was Chief Financial Officer of Presidio Bank, a San Francisco-based bank that was then in organization. In this capacity, he was responsible for overall operations implementation and all back office functions including information technology, human resources, accounting and branch operations. Prior to this, Mr. Czajka was Executive Vice President and Chief Financial Officer of North Valley Bancorp, a publicly-traded multi-bank holding company located in Redding, California. From 1994 through 2000, Mr. Czajka held the position of Vice President, Corporate Controller for Pacific Capital Bancorp in Santa Barbara, California.

**Walter Duchanin** has been our Executive Vice President and Chief Credit Officer since 1995 and our Senior Vice President and Senior Loan Officer from 1992 to 1995. From 1988 to 1992, he was the Senior Vice President and Credit Administrator of Simi Valley Bank, and from 1983 to 1988, he was Group Vice President of Marathon National Bank. Mr. Duchanin’s banking experience also includes American International Bank and Bank of America. Mr. Duchanin received a Bachelors of Science degree in finance from USC.

**Nick Pi** has been our Executive Vice President and Group Manager since 2006 and our Senior Vice President and Corporate Banking Officer from 2003 to 2006. Before joining Preferred Bank, Mr. Pi was the

Senior Vice President and Commercial Real Estate Lending Team Leader of Chinatrust Bank (U.S.A.) from 2000 to 2003. Prior to this, he held various corporate titles from Assistant Vice President to Senior Vice President at Chinatrust bank (U.S.A.), mainly in the branch operation and lending fields from 1995 to 2000. His lending and credit experience also includes Grand Pacific Financing Corporation from 1989 to 1995, an affiliate of China Trust Group. Mr. Pi received a BA degree in Business School from NTU, Taiwan and a MBA degree from ESU.

**ITEM 1B. UNRESOLVED STAFF COMMENTS**

None.

**ITEM 2. PROPERTIES**

We do not own any of our offices or other facilities. Our corporate headquarters and main branch are located at 601 S. Figueroa Street, 20th Floor, Los Angeles, California 90017. The lease for this floor extends until August 31, 2008, with one option for us to extend the term of the lease for five years. The total lease expenses for 2006 was \$313,000 related to this lease.

At December 31, 2006, we maintained ten full-service branch offices in Alhambra, Century City, City of Industry, Torrance, Arcadia, Irvine, Diamond Bar, Valencia, Santa Monica and Chino, California all of which we lease. We believe that no single lease is material to our operations.

We believe that our existing facilities are adequate for our present purposes. We believe that, if necessary, we could secure alternative facilities on similar terms without adversely affecting our operations. Total lease expense was \$1,308,000 for the year ended December 31, 2006 and \$1,235,000 for December 31, 2005.

We believe that our existing facilities are adequate for our present purposes. We believe that, if necessary, we could secure alternative facilities on similar terms without adversely affecting our operations.

The following table provides certain information with respect to our leased branch locations.

<u>Location</u>	<u>Address</u>	<u>Current Lease Term Expiration Date</u>	<u>Square Footage</u>	<u>Total Deposits at December 31, 2006</u> (In 000's)
<b>Los Angeles County</b>				
Alhambra	325 E. Valley Blvd.	03/31/09	6,000	\$174,040
Arcadia	1469 S. Baldwin Avenue	02/28/08	2,600	73,623
Century City	1801 Century Park East, Suite 100	06/30/11	4,416	54,002
City of Industry	17515- A Colima Road	03/14/15	5,610	108,567
Diamond Bar	1373 S. Diamond Bar Blvd.	11/30/09	3,440	85,495
Los Angeles (Head Office & branch)	601 S. Figueroa Street, 20th Floor	08/31/08	15,648	368,705
Santa Monica	524 Wilshire Blvd.	08/31/12	1,355	28,064
Torrance	3501 Sepulveda Blvd., Suite 107	06/30/16	4,800	184,063
Valencia	24501 Town Center Drive, Suite 103	11/30/11	2,926	10,624
<b>Orange County</b>				
Irvine	2301 Dupont Drive, Suite 150	05/31/09	3,584	50,385
<b>San Bernardino County</b>				
Chino	3926 Grand Avenue, #E	10/14/10	2,973	23,775

**ITEM 3. LEGAL PROCEEDINGS**

From time to time we are a party to claims and legal proceedings arising in the ordinary course of business. There are no pending legal proceedings or, to the best of our knowledge, threatened legal proceedings, to which we are a party which may have a material adverse effect upon our financial condition, results of operations and business prospects.

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

There was no submission of matters to a vote of security holders during the fourth quarter of the year ended December 31, 2006.

## PART II

### ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

#### *Market Information*

Our Common Stock commenced trading on the Nasdaq Global Market on February 15, 2005 under the symbol "PFBC." Prior to being listed on the Nasdaq National Market, our common stock was listed for trading on the OTC Bulletin Board under the symbol "PFBL." While listed for trading on the OTC Bulletin Board, there was limited trading at widely varying prices and on a number of days, there were no trades at all in our common stock.

The initial public offering price of our common stock on February 14, 2005 was \$25.33 per share. Our common stock closed at \$40.74 on March 29, 2007 and there were 10,414,132 outstanding shares of our common stock. The number of shares and per share data has been adjusted to reflect our February 20, 2007 three-for-two stock split effected in the form of a dividend.

The following table sets forth the high and low sales prices for our common stock for the periods indicated as reported by the NASDAQ, as well as the cash dividends declared per share during the last two years:

	<u>High</u>	<u>Low</u>	<u>Cash Dividends Declared</u>
<b>2005</b>			
First Quarter (1/1 – 2/14) . . . . .	\$14.67	\$14.67	—
First Quarter (2/15 – 3/31) . . . . .	\$30.00	\$25.33	\$0.10
Second Quarter . . . . .	\$28.05	\$24.67	\$0.10
Third Quarter . . . . .	\$28.67	\$26.11	\$0.11
Fourth Quarter . . . . .	\$30.66	\$26.17	\$0.12
<b>2006</b>			
First Quarter . . . . .	\$34.00	\$29.42	\$0.13
Second Quarter . . . . .	\$36.11	\$32.91	\$0.13
Third Quarter . . . . .	\$41.53	\$35.28	\$0.13
Fourth Quarter . . . . .	\$40.70	\$35.29	\$0.14

The above sales prices and cash dividends declared per share amounts have been retroactively adjusted to reflect our February 2007 three-for-two stock split.

#### *Holdings*

As of March 29, 2007, 10,414,132 shares of the Bank's common stock were held by 131 shareholders of record.

#### *Dividends*

On January 25, 2007 we declared a cash dividends in the amount of \$0.17 per share, the cash dividend was paid on March 07, 2007 to stockholders' of record at the close of business on February 21, 2007.

We began paying dividends on a quarterly basis in the first quarter of 2005, subject to regulatory, capital and contractual constraints. Any determination to pay dividends in the future will, however, be at the discretion of our board of directors and will depend upon our earnings, financial condition, results of operations, capital requirements, available investment opportunities, regulatory restrictions, contractual restrictions and other factors that our board of directors may deem relevant. Accordingly, there can be no assurance that any stock or cash dividends will be declared in the future, and if any are declared, what amount they will be.

Because we are a California state-chartered bank, our ability to pay dividends or make distributions to shareholders is subject to restrictions set forth in the California Financial Code. California Financial Code Section 642 restricts the amount available for cash dividends by state-chartered banks to the lesser of: (1) retained earnings; or (2) the bank's net income for its last three fiscal years (less any distributions to shareholders made during such period).

However, Section 643 of the California Financial Code provides that notwithstanding the provisions of Section 642, a state-chartered bank may, with the prior approval of the California Commissioner, make a distribution to its shareholders in an amount not exceeding the greater of:

- retained earnings;
- net income for a bank's last preceding fiscal year; or
- net income of the bank for its current fiscal year.

If the California Commissioner finds that the shareholders' equity of the Bank is not adequate or that the payment of a dividend would be unsafe or unsound for the Bank, the California Commissioner may order the Bank not to pay a dividend to the Bank's shareholders.

As of December 31, 2006, we could have paid \$38.5 million in dividends without the approval of the California Commissioner.

In addition, under California law, the California Commissioner has the authority to prohibit a bank from engaging in business practices which the California Commissioner considers to be unsafe or injurious to its business or financial condition. It is possible, depending on our financial condition and other factors, that the California Commissioner could assert that the payment of dividends or other payments to our shareholders might under some circumstances be unsafe or injurious to our business or financial condition and prohibit such payment.

The FDIC also has the authority to prohibit a bank from engaging in business practices which the FDIC considers to be unsafe or unsound. It is possible, depending upon our financial condition and other factors, that the FDIC could assert that the payment of dividends or other payments might under some circumstances be such an unsafe or unsound practice and prohibit such payment.

***Issuer's Purchases of Equity Securities.*** We did not repurchase any of our equity securities during the fourth quarter of 2006.

***Securities Authorized for Issuance Under Equity Compensation Plans.***

The following table provides information as of December 31, 2006 regarding equity compensation plans under which equity securities of the Bank were authorized for issuance.

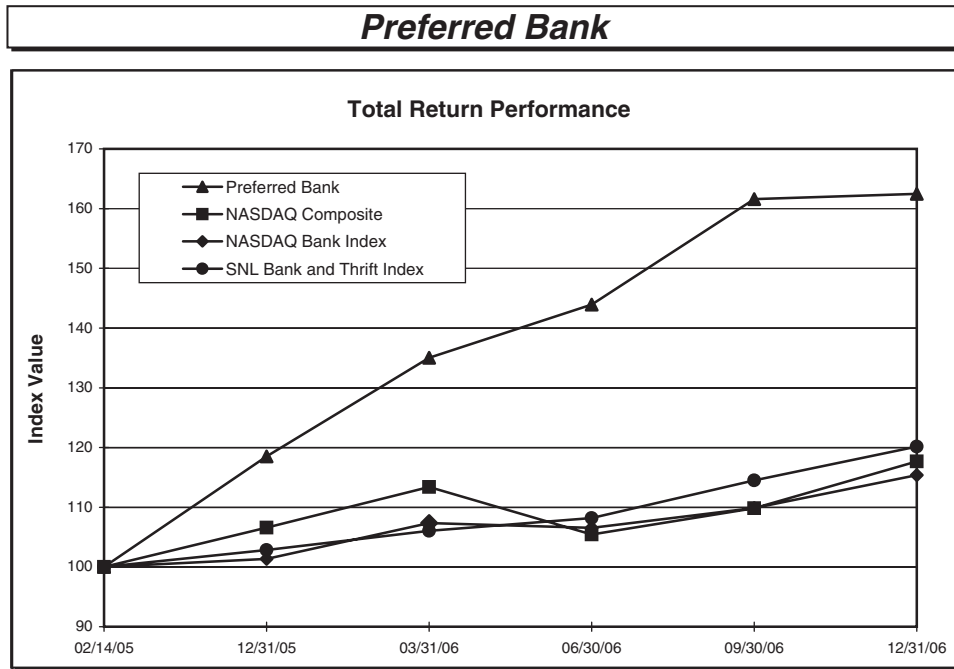
<u>Plan Category</u>	<u>Number of Securities to be issued upon exercise of outstanding options (a)</u>	<u>Weighted average exercise price of outstanding options (b)</u>	<u>Number of securities available for future issuance under equity compensation plans excluding securities reflected in column (a) ©</u>
Equity Incentive plans approved by security holders . . . . .	964,500	\$20.67	1,245,750
Equity Incentive plans not approved by security holders . . . . .	—	—	—
	964,500		1,245,750

The shares data reflected above has been adjusted to reflect our February 20, 2007 three for two stock split effected in the form of a dividend.



**Stock Performance Graph**

The following graph shows a comparison of stockholder return on the Bank's common stock based on the market price of the common stock assuming the reinvestment of dividends, for the period beginning February 15, 2005 assuming an investment of \$100 in each as of February 15, 2005. The Bank is not included in either of these indices. Total shareholder return for the Bank, as well as for the indices, is based on the cumulative amount of dividends for a given period (assuming dividend reinvestment) and the difference between the share price at the beginning and at the end of the period. This graph is historical only and may not be indicative of possible future performance of the common stock.



<u>Index</u>	<u>Period Ending</u>					
	<u>02/14/05</u>	<u>12/31/05</u>	<u>03/31/06</u>	<u>06/30/06</u>	<u>09/30/06</u>	<u>12/31/06</u>
Preferred Bank . . . . .	100.00	118.52	135.03	143.94	161.58	162.47
NASDAQ Composite . . . . .	100.00	106.60	113.40	105.45	109.82	117.68
NASDAQ Bank Index . . . . .	100.00	101.37	107.36	106.56	109.89	115.38
SNL Bank and Thrift Index . . . . .	100.00	102.84	106.04	108.20	114.51	120.17

## ITEM 6. SELECTED FINANCIAL DATA

The following table shows our selected historical financial data for the periods indicated. You should read our selected historical financial data, together with the notes thereto, in conjunction with the more detailed information in our financial statements and related notes and “Management’s Discussion and Analysis of Financial Condition and Results of Operations” included elsewhere in this Form 10-K.

Our financial condition data as of December 31, 2006 and 2005 and our statement of income data for the years ended December 31, 2006, 2005 and 2004 have been derived from our audited historical financial statements included elsewhere in this Form 10-K.

Our financial condition data as of December 31, 2004, 2003 and 2002 and our statement of income data for the year ended December 31, 2003 and 2002 have been derived from our audited historical financial statements that are not included in this Form 10-K.

	At or for the Year Ended December 31,				
	2006	2005	2004	2003	2002
	(Dollars in thousands, except per share data)				
<b>Financial Condition Data:</b>					
Total assets . . . . .	\$1,348,841	\$1,136,720	\$907,270	\$761,825	\$706,052
Total deposits . . . . .	1,161,344	975,467	801,535	662,812	614,868
Investments securities available-for sale, at fair value sale . . . . .	198,689	162,935	164,635	155,869	97,961
Loans and leases, gross . . . . .	997,317	771,143	615,961	504,053	448,512
Cash and due from banks . . . . .	26,878	25,123	35,212	22,960	24,351
Other real estate owned <sup>(1)</sup> . . . . .	—	—	8,258	8,258	8,188
Shareholders’ equity . . . . .	145,932	123,846	76,808	67,736	59,918
<b>Statement of Income Data:</b>					
Interest income . . . . .	\$ 90,262	\$ 60,082	\$ 38,643	\$ 34,376	\$ 33,902
Interest expense . . . . .	31,424	16,062	7,447	8,696	10,718
Net interest income . . . . .	58,838	44,020	31,196	25,680	23,184
Provision for credit losses . . . . .	1,960	2,110	1,550	2,100	10,146
Net interest income after provision for loan and lease losses . . . . .	56,878	41,910	29,646	23,580	13,038
Noninterest income . . . . .	3,028	3,868	4,199	4,923	4,514
Noninterest expense . . . . .	20,017	17,571	15,339	13,774	10,261
Income before provision for income taxes . . .	39,889	28,207	18,506	14,729	7,291
Provision for income taxes . . . . .	16,538	11,382	7,354	5,696	2,888
Net income . . . . .	<u>\$ 23,351</u>	<u>\$ 16,825</u>	<u>\$ 11,152</u>	<u>\$ 9,033</u>	<u>\$ 4,403</u>

	At or for the Year Ended December 31,				
	2006	2005	2004	2003	2002
	(Dollars in thousands, except per share data)				
<b>Share Data:</b>					
Net income per share, basic <sup>(2)(10)</sup> . . . . .	\$ 2.29	\$ 1.72	\$ 1.35	\$ 1.11	\$ 0.54
Net income per share, diluted <sup>(2)(10)</sup> . . . . .	\$ 2.21	\$ 1.65	\$ 1.28	\$ 1.05	\$ 0.51
Book value per share <sup>(3)(10)</sup> . . . . .	\$ 14.20	\$ 12.34	\$ 9.22	\$ 8.28	\$ 7.38
Shares outstanding at period end <sup>(10)</sup> . . . . .	10,274,706	10,037,856	8,331,273	8,182,473	8,122,923
Weighted average number of shares outstanding, basic <sup>(2)(10)</sup> . . . . .	10,194,515	9,782,645	8,277,597	8,160,479	8,097,171
Weighted average number of shares outstanding, diluted <sup>(2)(10)</sup> . . . . .	10,556,282	10,195,958	8,713,851	8,573,313	8,586,279
<b>Selected Other Balance Sheet Data<sup>(4):</sup></b>					
Average assets . . . . .	\$ 1,180,749	\$ 1,006,222	\$ 840,265	\$ 752,097	\$ 679,185
Average earning assets . . . . .	1,142,126	969,019	791,227	707,588	636,053
Average shareholders' equity . . . . .	134,384	110,250	71,896	63,704	60,285
<b>Selected Financial Ratios<sup>(4):</sup></b>					
Return on average assets . . . . .	1.98%	1.67%	1.33%	1.20%	0.65%
Return on average shareholders' equity <sup>(3)</sup> . . . . .	17.38	15.26	15.51	14.18	7.30
Shareholders' equity to assets <sup>(5)</sup> . . . . .	10.82	10.90	8.47	8.89	8.49
Net interest margin <sup>(6)</sup> . . . . .	5.15	4.54	3.94	3.63	3.65
Efficiency ratio <sup>(7)</sup> . . . . .	32.35	36.69	43.34	45.01	37.05
<b>Selected Asset Quality Ratios:</b>					
Non-performing loans to total loans and leases <sup>(8)</sup> . . . . .	0.11%	— %	0.06%	0.20%	1.43%
Non-performing assets to total assets <sup>(9)</sup> . . . . .	0.08	—	0.95	1.22	2.05
Allowance for loan and lease losses to total loans and leases . . . . .	1.03	1.16	1.09	1.22	2.06
Allowance for loan and lease losses to non-performing loans . . . . .	913.93	—	1,758.64	616.80	144.23
Net charge-offs (recoveries) to average loans and leases . . . . .	0.08	(0.02)	0.18	1.11	1.38

- (1) These amounts include all property held by us as a result of foreclosure.
- (2) Net income per share, basic is based on the weighted average shares of common stock outstanding during the period. Net income per share, diluted is based on the weighted average shares of common stock plus common stock equivalents determined using the treasury stock method.
- (3) Book value per share represents our shareholders' equity divided by the number of shares of common stock issued and outstanding at the end of the period indicated (exclusive of shares exercisable under our stock option plans).
- (4) Average balances used in this chart and throughout this annual report are based on daily averages. Percentages as used throughout this annual report have been rounded to the closest whole number, tenth or hundredth as the case may be.
- (5) For a discussion of the components of the capital ratios, see "Management's Discussion and Analysis of Financial Condition and Results of Operations—Capital Resources."
- (6) Net interest margin is net interest income expressed as a percentage of average total interest-earning assets.
- (7) The efficiency ratio is the ratio of noninterest expense divided by the sum of net interest income before the provision for credit losses plus noninterest income.
- (8) Non-performing loans consist of loans on nonaccrual and loans past due 90 days or more and restructured debt.
- (9) Non-performing assets consist of non-performing loans, restructured debt and other real estate owned.
- (10) Adjusted to reflect 3 for 2 stock split effected in the form of a dividend, distributed on February 20, 2007.

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

Our discussion and analysis of earnings and related financial data are presented herein to assist investors in understanding the financial condition of our Company at December 31, 2006 and 2005, and the results of operations for the years ended December 31, 2006, 2005 and 2004. This discussion should be read in conjunction with the consolidated financial statements and related footnotes of our Company presented elsewhere herein. Historical share and per share data has been adjusted to reflect our February 2007 three for two stock split.

### **Overview**

We are a California chartered, full-service commercial bank focused on the Chinese-American market. We conduct our banking business from our headquarters in Los Angeles, and through our eleven full-service branch banking offices located in Alhambra, Century City, City of Industry, Torrance, Arcadia, Irvine, Diamond Bar, Valencia, Santa Monica and Chino, California.

We derive our income primarily from interest received on our loan and investment securities portfolios, and fee income we receive in connection with servicing our loan and deposit customers. Our major operating expenses are the interest we pay on deposits and borrowings, and the salaries and related benefits we pay our management and staff. We rely primarily on locally-generated deposits, most of which we receive from the Chinese-American market within Southern California, to fund our loan and investment activities.

One of our strategic goals is to focus on improving profitability while achieving reasonable but controlled asset growth. To attain this goal, we plan to continue to expand our branch network in Southern California. In December 2002, we established a branch office in Diamond Bar and in January 2004, we opened our Valencia Branch. To further expand our franchise, we opened our Santa Monica and Chino Branches in April and December 2005, respectively.

For the year-ended December 31, 2006 the Bank recorded net earnings of \$23.4 million as compared to \$16.8 million for December 31, 2005 representing a 39% increase from 2005. The increase in net earnings during 2006 is primarily due to an increase in our net interest income as a result of growth in our loan and deposit portfolio and the Bank's asset sensitive balances in the rising interest rate environment. See—"Results of Operation".

For the year-ended December 31, 2005 the Bank recorded net earnings of \$16.8 million as compared to \$11.2 million for December 31, 2004 representing a 51% increase from 2004. The increase in net earnings during 2005 is primarily due to an increase in our net interest income as a result of growth in our loan and deposit portfolio and the Bank's asset sensitive balances in the rising interest rate environment.

In response to changes in interest rates, we changed the mix of our assets by accelerating the growth of our loan originations, especially commercial real estate loans, reducing the amount of federal funds sold and investing in higher-yielding investment securities. We expect to continue to shift our asset mix in this manner for the foreseeable future subject to changes in market conditions and other factors described in this annual report.

### **Critical Accounting Policies**

Our accounting policies are integral to understanding the financial results reported. Our most complex accounting policies require management's judgment to ascertain the valuation of assets, liabilities, commitments and contingencies. We have established detailed policies and control procedures that are intended to ensure valuation methods are well controlled and consistently applied from period to period. In addition, these policies and procedures are intended to ensure that the process for changing methodologies occurs in an appropriate manner. The following is a brief description of our current accounting policies involving significant management valuation judgments.

### ***Allowance for Loan and Lease Losses***

The allowance for loan and lease losses, or ALLL, represents our best estimate of losses inherent in the existing loan and lease portfolio. The allowance for loan and lease losses is increased by the provision for loan and lease losses charged to expense and reduced by loans and leases charged off, net of recoveries.

We evaluate our allowance for loan and lease losses quarterly. We believe that the allowance for loan and lease losses is a “critical accounting estimate” because it is based upon management’s assessment of various factors affecting the collectibility of the loans and leases, including current economic conditions, past credit experience, delinquency status, the value of the underlying collateral, if any, and a continuing review of the portfolio of loans and leases.

Like all financial institutions, we maintain an ALLL based on a number of quantitative and qualitative factors. The amount of the allowance is based on management’s evaluation of the collectibility of the loan and lease portfolio and that evaluation is based on historical loss experience and other significant factors. These other significant factors include the level and trends in delinquent, non-accrual and adversely classified loans and leases, trends in volume and terms of loans and leases, levels and trends in credit concentrations, effects of changes in underwriting standards, policies, procedures and practices, national and local economic trends and conditions, changes in capabilities and experience of lending management and staff and other external factors including industry conditions, competition and regulatory requirements.

We cannot provide you with any assurance that further economic difficulties or other circumstances which would adversely affect our borrowers and their ability to repay outstanding loans and leases will not occur. These difficulties or other circumstances could result in increased losses in our loan and lease portfolio, which could result in actual losses that exceed reserves previously established.

### ***Investment Securities***

We assess, at each reporting date, whether there is an “other-than-temporary” impairment to our investment securities. Such impairment is recognized in current earnings rather than in other comprehensive income. We examine all individual securities that are in an unrealized loss position at each reporting date for other-than-temporary impairment. Specific investment level factors we examine to assess impairment include the severity and duration of the loss, an analysis of the issuer of the securities and if there has been any cause for default on the securities and any change in the rating of the securities by the various rating agencies. Additionally, we reexamine the financial resources and overall ability the Bank has and the intent management has to hold the securities until their fair values recover.

In November 2005, the FASB issued Staff Position (“FSP”) Nos. FAS 115-1 and 124-1 to address the determination as to when an investment is considered impaired, whether that impairment is other than temporary and the measurement of an impaired loss. This FSP nullified certain requirements of Emerging Issues Task Force 03-1 *The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments* (EITF 03-1), and references existing guidance on other than temporary impairment. Furthermore, this FSP creates a three step process in determining when an investment is considered impaired, whether that impairment is other than temporary, and the recognition of impairment loss equal to the difference between the investment’s cost and its fair value. The FSP is effective for reporting periods beginning after December 15, 2005. The adoption of this FSP did not have a material impact on the Company’s financial condition or results of operations.

### **Stock Split Effected in the form of a Stock Dividend**

On January 25, 2007 Preferred Bank announced that its Board of Directors had approved a 3-for-2 stock split to be effected in the form of stock a dividend. Each stockholder of record at the close of business on

February 5, 2007 received one additional share of common stock for every two shares of common stock that they owned as of such date. The additional shares were distributed on February 20, 2007. A stockholder who would otherwise be entitled to receive a fractional share of common stock received in lieu thereof, cash in a proportional amount based on the closing price of the common stock on the Nasdaq Stock Exchange on the record date. After giving effect to the stock split, we have retroactively adjusted the number of common shares outstanding at December 31, 2006 and 2005 to 10,274,632 and 10,037,782, respectively. Accordingly, all references in the accompanying statement of financial condition, results of operations and statement of changes in shareholders' equity to the number of common stock shares and earnings per share amounts have been retroactively adjusted for all period presented.

## Results of Operations

The following tables summarize key financial results for the periods indicated:

	Year Ended December 31,		
	2006	2005	2004
	(Dollars in thousands, except per share data)		
Net income	\$23,351	\$16,825	\$11,152
Net income per share, basic <sup>(1)</sup>	\$ 2.29	\$ 1.72	\$ 1.35
Net income per share, diluted <sup>(1)</sup>	\$ 2.21	\$ 1.65	\$ 1.28
Return on average assets	\$ 1.98%	\$ 1.67%	\$ 1.33%
Return on average shareholders' equity	\$ 17.38%	\$ 15.26%	\$ 15.51%

(1) Adjusted to reflect 3 for 2 stock split, effected in the form of dividend, distributed on February 20, 2007.

### Year Ended December 31, 2006 Compared to Year Ended December 31, 2005

	Year Ended December 31,		
	2006	2005	Increase (Decrease)
	(Dollars in thousands, except per share data)		
<b>Statement of Income Data:</b>			
Interest income	\$90,262	\$60,082	\$30,180
Interest expense	31,424	16,062	15,362
Net interest income	58,838	44,020	14,818
Provision for credit losses	1,960	2,110	(150)
Net interest income after provision for loan and lease losses	56,878	41,910	14,968
Noninterest income	3,028	3,868	(840)
Noninterest expense	20,017	17,571	2,446
Income before income taxes	39,889	28,207	11,682
Income taxes	16,538	11,382	5,156
Net income	\$23,351	\$16,825	\$ 6,526
Net income per share, basic <sup>(1)</sup>	\$ 2.29	\$ 1.72	\$ 0.57
Net income per share, diluted <sup>(1)</sup>	\$ 2.21	\$ 1.65	\$ 0.56

(1) Adjusted to reflect 3 for 2 stock split, effected in the form of dividend distributed on February 20, 2007.

Net income increased 39% to \$23.4 million, or \$2.21 per diluted share, for the year-ended December 31, 2006, from \$16.8 million, or \$1.65 per diluted share, for the year ended December 31, 2005. Our return on average assets was 1.98% and return on average shareholders' equity was 17.38% for the year ended December 31, 2006, compared to 1.67% and 15.26%, respectively, for the year ended December 31, 2005.



Net income improved significantly in 2006 from 2005, principally as a result of an increase in net interest income by \$14.8 million, partially offset by an increase in noninterest expense by \$2.4 million and an increase in the provision for income taxes by \$5.2 million.

The \$14.8 million, or 34%, increase in net interest income was primarily as a result of the growth in the loan portfolio across all loan products coupled with a 61 basis point improvement in our net interest margin. Our overall cost of funds in 2006 increased by 152 basis points to 3.83%, compared to 2.31% for 2005. The combined impact of a rising interest rate environment and increased competition in the deposit market were the primary drivers of our increased cost of funds during 2006.

As of December 31, 2006, 85% of our loan portfolio was tied to the Prime Rate, which has the potential to reprice daily, and 13% was tied to the London Interbank Offer Rate, or LIBOR, or other indices, which reprice periodically. Approximately 37% of our loan portfolio had a floor interest rate at various levels, which would provide us with some protection in a falling interest rate environment should the Prime Rate decline to a level below the floor interest rate. Approximately 1% of our loan portfolio had interest rate ceilings at various rates limiting the amount of interest rate increases that can be passed on to the borrower. Our weighted average maturity of certificates of deposit at December 31, 2006 was 4 months. As a result, our interest-bearing liabilities generally reprice slower than our loan portfolio and our net income should be positively impacted by a rising interest rate environment.

*Year Ended December 31, 2005 Compared to Year Ended December 31, 2004*

	<b>Year Ended December 31,</b>		
	<b>2005</b>	<b>2004</b>	<b>Increase (Decrease)</b>
<b>(Dollars in thousands, except per share data)</b>			
<b>Statement of Income Data:</b>			
Interest income . . . . .	\$60,082	\$38,643	\$21,439
Interest expense . . . . .	16,062	7,447	8,615
Net interest income . . . . .	44,020	31,196	12,824
Provision for credit losses . . . . .	2,110	1,550	560
Net interest income after provision for credit losses . . . . .	41,910	29,646	12,264
Noninterest income . . . . .	3,868	4,199	(331)
Noninterest expense . . . . .	17,571	15,339	2,232
Income before provision for income taxes . . . . .	28,207	18,506	9,701
Provision for income taxes . . . . .	11,382	7,354	4,028
Net income . . . . .	<u>\$16,825</u>	<u>\$11,152</u>	<u>\$ 5,673</u>
Net income per share, basic <sup>(1)</sup> . . . . .	<u>\$ 1.72</u>	<u>\$ 1.35</u>	<u>\$ 0.37</u>
Net income per share, diluted <sup>(1)</sup> . . . . .	<u>\$ 1.65</u>	<u>\$ 1.28</u>	<u>\$ 0.37</u>

(1) Adjusted to reflect 3 for 2 stock split, effected in the form of dividend distributed on February 20, 2007.

Net income increased 50.9% to \$16.8 million, or \$1.65 per diluted share, for the year ended December 31, 2005, from \$11.2 million, or \$1.28 per diluted share, for the year ended December 31, 2004. Our return on average assets was 1.67% and return on average shareholders' equity was 15.26% for the year ended December 31, 2005, compared to 1.33% and 15.51%, respectively, for the year ended December 31, 2004.

Net income improved significantly in 2005 from 2004, principally as a result of an increase in net interest income of \$12.8 million, partially offset by an increase in noninterest expense of \$2.2 million and increase in provision for income taxes of \$4.0 million.

The \$12.8 million, or 41.1%, increase in net interest income primarily resulted from increased loan volume, in particular commercial real estate loans, and a 15 basis point improvement in net interest margin. Our overall cost of funds in 2005 increased by 106 basis points to 2.31%, compared to 1.25% for 2004. The combined impact of an increasing interest rate environment and increased competition in the deposit market were the primary drivers of our increased cost of funds during 2005.

As of December 31, 2005, 89% of our loan portfolio was tied to the Prime Rate, which reprices daily, and 9% was tied to the London Interbank Offer Rate, or LIBOR, or other indices, which reprice periodically. Approximately 36% of our loan portfolio had a floor interest rate at various levels, which can provide us with protection in a falling interest rate environment should the Prime Rate decline to a level below the floor interest rate. Approximately 2% of our loan portfolio had interest rate ceilings at various rates limiting the amount of interest rate increases that can be passed on to the borrower. Our weighted average maturity of certificates of deposit at December 31, 2005 was 4 months. As a result, our interest-bearing liabilities generally reprice much slower than our loan portfolio and our net income should be positively impacted by a rising interest rate environment.

### ***Net Interest Income and Net Interest Margin***

Year ended December 31, 2006 compared to 2005

Net interest income before the provision for credit losses for the year ended December 31, 2006 increased \$14.8 million, or 34%, from \$44.0 million to \$58.8 million for the year ended December 31, 2005. This increase was due to an increase in interest income of \$30.2 million, partially offset by an increase in interest expense of \$15.4 million. Total interest expense increased primarily as a result of increases in interest rates on time certificates of deposit maturing and being replaced at current prevailing rates. The \$30.2 million increase in total interest income was due to both an increase in interest rates and an increase in the volume of loans. Rising short-term interest rates also contributed to the increase in total interest income.

The average yield on our interest-earning assets increased significantly to 7.93% in year ended December 31, 2006 from 6.23% in the year ended December 31, 2005. The increase was mainly due to the rising interest rate environment with lower rate loans maturing and being replaced by loans at higher prevailing rates, as well as investment securities maturing or being called and reinvested at higher prevailing rates.

The cost of average interest-bearing liabilities increased to 3.83% in the year ended December 31, 2006 from 2.31% in the year ended December 31, 2005. The increase was primarily driven by rising interest rates with lower cost time deposits maturing and being replaced at higher prevailing rates.

Year ended December 31, 2005 compared to 2004

Our net interest income before the provision for loan and lease losses for the year ended December 31, 2005 increased \$12.8 million, or 41.1%, as compared to the year ended December 31, 2004. This increase was due to an increase in interest income of \$21.4 million, partially offset by an increase in interest expense of \$8.6 million. Total interest expense increased primarily as a result of increases in interest rates with time certificates of deposit maturing and being replaced at current prevailing rates. The \$21.4 million increase in total interest income was due to both rising interest rates and an increase in the volume of loans.

The average yield on our interest-earning assets increased significantly to 6.23% in year ended December 31, 2005 from 4.92% in the year ended December 31, 2004. The increase was mainly due to the rising

interest rate environment with lower rate loans maturing and being replaced by loans at higher prevailing rates, as well as investment securities maturing or being called and reinvested at higher prevailing rates.

The cost of average interest-bearing liabilities increased to 2.31% for the year ended December 31, 2005 from 1.25% for the year ended December 31, 2004. The increase was primarily driven by rising interest rates with lower cost time deposits maturing and being replaced at higher prevailing rates. The increase in the ratio of time certificates of deposit to average interest-bearing deposits from 70.88% to 72.57%, and the increase in the cost of FHLB long-term borrowings all contributed to the increase in the cost of average interest-bearing liabilities.

Our interest income, interest expense, net interest income, and net interest margin are influenced by the distribution of our assets and liabilities and the income earned and costs incurred on such assets and liabilities. The following table presents, for the periods indicated, the information regarding the distribution of average assets, liabilities and shareholders' equity, as well as the net interest income from average interest-earning assets and the resulting yields expressed in percentages. Non-accrual loans are included in the calculation of average loans and leases while non-accrued interest thereon is excluded from the computation of yields earned.

	Year Ended December 31, 2006			Year Ended December 31, 2005			Year Ended December 31, 2004		
	Average Balance	Interest Income or Expense	Average Yield or Cost	Average Balance	Interest Income or Expense	Average Yield or Cost	Average Balance	Interest Income or Expense	Average Yield or Cost
(Dollars in thousands)									
<b>ASSETS:</b>									
Interest-earning assets:									
Loans and leases <sup>(2)(3)</sup>	\$ 867,672	\$77,186	8.90%	\$ 692,320	\$50,443	7.29%	\$541,402	\$32,048	5.92%
Investments securities <sup>(1)</sup>	179,533	8,714	4.85	166,991	6,445	3.86	159,229	5,570	3.50
Federal funds sold	89,332	4,377	4.90	101,754	3,264	3.21	81,948	1,105	1.35
Certificate of deposits with other banks	2,401	108	4.50	4,716	144	3.05	6,390	133	2.08
Other earning assets <sup>(4)</sup>	3,590	189	5.26	3,238	108	3.34	2,258	85	3.76
Total interest-earning assets	1,142,528	90,574	7.93	969,019	60,404	6.23	791,227	38,941	4.92
Noninterest earning assets:									
Cash and due from banks	24,228			23,873			29,590		
Other assets	13,993			13,330			19,448		
Total assets	\$1,180,749			\$1,006,222			\$840,265		
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>									
Interest-bearing liabilities:									
Deposits:									
Interest-bearing demand	26,353	316	1.20	26,757	149	0.56	26,064	82	0.31
Money market	106,962	2,140	2.00	121,444	1,304	1.07	118,039	735	0.62
Savings	67,317	2,427	3.61	38,346	511	1.33	24,311	76	0.31
Time certificates of deposit	597,504	25,675	4.30	493,510	13,610	2.76	409,894	6,196	1.51
Total interest-bearing deposits	798,136	30,558	3.83	680,057	15,574	2.29	578,308	7,089	1.23
Short-term borrowings	1,071	58	5.42	302	11	3.64	41	1	2.44
Long-term debt	21,233	808	3.81	14,636	477	3.26	17,582	357	2.03
Total interest-bearing liabilities	820,440	31,424	3.83	694,995	16,062	2.31	595,931	7,447	1.25
Non-interest-bearing liabilities:									
Demand deposits	207,685			184,102			157,688		
Other liabilities	18,237			16,875			14,750		
Total liabilities	1,046,362			895,972			768,369		
Shareholders' equity	134,387			110,250			71,896		
Total liabilities and shareholders' equity	1,180,749			1,006,222			840,265		
Net interest income		59,150			44,342			31,494	
Net interest spread			4.10			3.92			3.67
Net interest margin			5.18%			4.58%			3.98%

(1) Yields on securities have been adjusted to a tax-equivalent basis.

(2) Includes average non-accrual loans and leases.

(3) Net loan and lease fees of \$4.5 million, \$3.1 million and \$1.5 million for the year ended December 31, 2006, 2005 and 2004, respectively, are included in the yield computations.

(4) Includes Federal Home Loan Bank stock.

As a result of the combination of (1) increased interest income, primarily due to increase loan volume and rising interest rates and (2) increased interest expense at a smaller level in response to the increasing interest rate environment, our net interest margin increased to 5.18% in 2006 from 4.58% in 2005.

In addition to the distribution, yields and costs of our assets and liabilities, our net income is also affected by changes in the volume of and rates on our assets and liabilities. The following table shows the change in interest income and interest expense and the amount of change attributable to variances in volume, rates and the combination of volume and rates based on the relative changes of volume and rates.

	Year Ended December 31,							
	2006 vs. 2005				2005 vs. 2004			
	Net Change	Rate	Volume	Mix	Net Change	Rate	Volume	Mix
	(In thousands)							
Interest income:								
Loans and leases	\$26,743	\$13,967	\$12,776	\$—	\$18,397	\$ 8,336	\$10,061	\$—
Investment securities <sup>(1)</sup>	2,269	1,785	484	—	875	594	281	—
Federal funds sold	1,113	1,511	(398)	—	2,159	1,837	322	—
Interest-bearing deposits with other banks	(36)	35	(71)	—	11	52	(41)	—
Other earning assets	81	69	12	—	21	(11)	32	—
Total interest income	<u>30,170</u>	<u>17,367</u>	<u>12,803</u>	<u>—</u>	<u>21,463</u>	<u>10,808</u>	<u>10,655</u>	<u>—</u>
Interest expense:								
Interest-bearing demand	167	169	(2)	—	67	65	2	—
Money market	836	991	(155)	—	569	547	22	—
Savings	1,916	1,530	386	—	435	370	65	—
Time certificates of deposit	12,065	9,197	2,868	—	7,414	5,943	1,471	—
Short-term borrowings	47	19	28	—	10	1	9	—
Long-term debt	331	116	215	—	120	188	(68)	—
Total interest expense	<u>15,362</u>	<u>12,023</u>	<u>3,339</u>	<u>—</u>	<u>8,615</u>	<u>7,113</u>	<u>1,502</u>	<u>—</u>
Net interest income	<u>\$14,808</u>	<u>\$ 5,344</u>	<u>\$ 9,464</u>	<u>\$—</u>	<u>\$12,848</u>	<u>\$ 3,695</u>	<u>\$ 9,153</u>	<u>\$—</u>

(1) Amounts have been adjusted to a tax-equivalent basis.

As reflected above, due to our decision to increase our loan originations and to change the mix of our investment portfolio by increasing the amount of higher yielding investment securities, most of the increase in the net interest income during 2006 was attributable to the increases in the rate on interest earning assets which offset the increases in the cost of time certificates of deposit and savings.

### ***Provision for Credit Losses***

The provision for loan and lease losses in each period is a charge against earnings in that period. The provision is that amount required to maintain the allowance for loan and lease losses at a level that, in management's judgment, is adequate to absorb loan and lease losses inherent in the loan and lease portfolio.

The provision for credit losses for 2006 decreased slightly by \$150,000 to \$1.96 million from \$2.11 million for 2005. The bank's net loans and lease charge-offs increased \$768,000 to \$663,000 during 2006 from a \$105,000 recovery in 2005. The decrease in the provision for credit losses during 2006 is the result of the application management's established allowance for loan and lease loss methodology. Although net loan and lease charge-offs increased for the same period, the application of the methodology's quantitative and qualitative components resulted in management's judgment that the provision and overall level of reserve is adequate for losses inherent in the portfolio as of December 31, 2006.

The provision for loan and lease losses for 2005 was \$2.1 million as compared to \$1.6 million for 2004. In 2005, we experienced minimum net loan and lease recoveries of \$105,000 as compared to net loan and lease charge-offs of \$1.0 million for 2004. The increase in our provision during 2005 represents the estimate of losses inherent in the existing loan and lease portfolio that increased considerably from 2004.

***Noninterest Income***

We earn noninterest income primarily through fees related to:

- services provided to deposit customers
- services provided in connection with trade finance
- services provided to current loan customers
- increases in the cash surrender value of bank owned life insurance policies

The following table presents, for the periods indicated, the major categories of noninterest income:

	<b>Year Ended December 31,</b>		
	<b>2006</b>	<b>2005</b>	<b>2004</b>
	(In thousands)		
Service charges and fees on deposit accounts . . . . .	\$1,660	\$2,297	\$2,393
Trade finance income . . . . .	777	707	729
Increase in cash surrender value of life insurance . . . . .	326	312	316
Net other real estate owned income . . . . .	—	195	526
Other income . . . . .	265	356	235
<b>Total noninterest income . . . . .</b>	<b><u>\$3,028</u></b>	<b><u>\$3,868</u></b>	<b><u>\$4,199</u></b>

Total noninterest income decreased by \$840,000 or 28%, to \$3.0 million during 2006 from \$3.9 million during 2005. The decrease in noninterest income was primarily attributed to a decrease in deposit service fee income as a result of an increase in the Bank’s earnings allowance which customers earn on their deposits due to the rising interest rate environment. In addition, in 2005 the Bank realized \$195,000 in operating rental income from other real estate owned (OREO) property sold in the first quarter of 2005.

Total noninterest income decreased by \$331,000 or 7.9%, to \$3.9 million during 2005 from \$4.2 million during 2004. The decline in noninterest income was attributed to a decrease in operating income from the other real estate owned (OREO) property which was sold in the first quarter of 2005 and a decrease in deposit fee income due to an increase in the Bank’s earnings allowance rate which customers earn on their deposits due to the rising interest rate environment.

Our results can be influenced by the unpredictable nature of gains and losses in connection with the sale of investment securities and other real estate owned. We do not engage in active securities trading; however, from time to time we sell securities in our portfolio to realize gains. It is likely we may continue this practice in the future. From time to time, we acquire real estate in connection with non-performing loan transactions, and sell such real estate to recoup a portion of the principal amount of the defaulted loans. These sales can result in gains or losses from time to time that are not expected to occur in predictable patterns during future periods.

Service charges on deposit accounts decreased primarily due to a decrease in account analysis fees associated with demand deposit activities.

***Noninterest Expense***

Noninterest expense is the cost, other than interest expense and the provision for loan and lease losses, associated with providing banking and financial services to customers and conducting our business.



The following table presents, for the periods indicated, the major categories of noninterest expense:

	Year Ended December 31,		
	2006	2005	2004
	(In thousands)		
Salaries and employee benefits . . . . .	\$12,216	\$10,252	\$ 9,741
Net occupancy expense . . . . .	2,303	2,163	1,826
Business development and promotion expense . . . . .	451	444	250
Professional fees . . . . .	1,948	1,534	855
Office supplies and equipment expense . . . . .	943	867	754
Other expense . . . . .	2,156	2,312	1,913
Total noninterest expense . . . . .	<u>\$20,017</u>	<u>\$17,571</u>	<u>\$15,339</u>

Total noninterest expense increased \$2.4 million, or 14% to \$20.0 million during 2006 from \$17.5 million during 2005. Salaries and employee benefits increased \$2.0 million, or 19%, primarily as a result of an increase in the number of employees and employee benefits. We had 132 and 122 full-time equivalent employees at December 31, 2006 and 2005, respectively. Also part of the increase in salary and employee benefits is due to stock options expense recorded in 2006 in the amount of \$752,000 as a result of adoption of SFAS 123R in 2006. Professional fees increased by approximately \$400,000 to \$1.9 million during 2006 from \$1.5 million in 2005 mainly due to the cost of preparation to implement section 404 of the Sarbanes-Oxley Act as well as complying with the provisions of the Federal Deposit Insurance Corporation Improvement or FDICIA and audit fees also increased significantly in connection with additional reporting and compliance requirements as a public company.

Total noninterest expense increased \$2.2 million, or 14.6%, to \$17.5 million during 2005 from \$15.3 million during 2004. Salaries and employee benefits increased approximately \$500,000, or 5.2%, as a result of an increase in the number of employees and employee benefits. We had 122 and 113 full-time equivalent employees at December, 2005 and 2004, respectively. We also opened two new branch offices in 2005 which resulted in an increase of the occupancy expense. Our professional fees included the audit fees also increased significantly in connection with additional reporting and compliance requirements as a public company.

***Provision for Income Taxes***

We recorded an income tax provision of \$16.5 million for 2006, \$11.4 million for 2005 and \$7.4 million for 2004. Our effective tax rates were 41.5%, 40.4% and 39.7% for 2006, 2005 and 2004, respectively, as compared to the statutory tax rate of 42.05%. The difference from the statutory rate for 2005 and 2004 is due to the nontaxable nature of income from municipal securities and earnings on cash surrender value of Bank-Owned Life Insurance. For 2006 the difference was due to the two items mentioned above as well as stock option expense associated with the adoption of SFAS No.123R.

**Financial Condition**

For the period between December 31, 2006 and December 31, 2005, our assets, loans and deposits grew at the rate of 18.6%, 29.3% and 19.1%, respectively. Our total assets at December 31, 2006 were \$1.3 billion compared to \$1.1 billion at December 31, 2005. Our earning assets at December 31, 2006 totaled \$1.3 billion compared to \$1.1 billion at December 31, 2005. Total deposits at December 31, 2006 and December 31, 2005 were \$1.2 billion and \$975.5 million, respectively.

### Loans and Leases

The largest component of our assets and source of interest income is our loan portfolio. The following table sets forth the amount of our loans and leases outstanding at the end of each of the periods indicated. We had no foreign loans or energy-related loans as of the dates indicated.

	Year Ended December 31,				
	2006	2005	2004	2003	2002
Loans and leases:					
Real estate—mini-perm . . . . .	\$438,280	\$372,251	\$358,220	\$250,993	\$214,661
Real estate—construction . . . . .	271,021	171,646	112,002	94,816	85,584
Commercial . . . . .	201,385	149,428	98,547	117,607	108,767
Trade finance . . . . .	86,067	76,700	45,951	37,829	31,439
Consumer . . . . .	45	121	222	348	446
Leases receivable and other . . . . .	519	997	1,018	2,460	7,615
Total gross loans and leases . . . . .	997,317	771,143	615,960	504,053	448,512
Less: allowance for loan and lease losses . . . . .	(10,236)	(8,939)	(6,724)	(6,168)	(9,257)
Deferred loan and lease fees, net . . . . .	(1,759)	(1,537)	(2,383)	(1,395)	(1,212)
Total net loans and leases . . . . .	<u>\$985,322</u>	<u>\$760,667</u>	<u>\$606,853</u>	<u>\$496,490</u>	<u>\$438,043</u>

Total gross loans and leases increased by \$226.2 million, or 29.3% during 2006 from the prior year. This growth partially reflects the strong commercial real estate market in Southern California during this period. This follows a similar increase in our portfolio which the bank has been experiencing in recent years. We had an increase of \$155.2 million, or 25.2% between December 31, 2005 and 2004.

Our real estate mini-perm loan portfolio grew significantly during 2006 by \$66.0 million or 17.7% to \$438.3 million from \$372.3 million at December 31, 2005. For the prior four years between 2005 and 2002 the growth trend for our real estate mini-perm has been as follows: during the year 2005 it grew by \$14.0 million, or 3.9%, million from \$358.2 million at December 31, 2004, during 2004 it grew by \$107.2 million, or 42.7%, from \$251.0 million at December 31, 2003, during 2003 it grew by \$36.3 million, or 16.9% from \$214.6 at December 31, 2002. We believe this growth reflects a combination of our marketing efforts as well as a strong real estate market.

The following table provides information about our real estate mini-perm portfolio by property type:

Property Type	At December 31, 2006	
	Amount	Percentage of Loans in Each Category in Total Loan Portfolio
	(Dollars in thousands)	
Commercial/Office . . . . .	\$ 75,456	7.56%
Industrial . . . . .	67,857	6.80
Retail . . . . .	64,594	6.48
Apartment 4+ . . . . .	25,019	2.51
Residential 1-4 . . . . .	52,043	5.22
Other . . . . .	153,311	15.37
Total . . . . .	<u>\$438,280</u>	<u>43.94%</u>

During 2006 real estate construction loans grew by \$99.4 million or 57.9% to \$271.0 million at December 31, 2006 from \$171.6 million at December 31, 2005, and grew in 2005 by \$59.6 million or 53.2%, from \$112.0 at December 31, 2006, and grew in 2004 by \$17.2 million, or 18.1%, from \$94.8 million at December 31, 2003. We expect the construction portfolio will continue to grow subject to market conditions and interest rates.

Commercial loans outstanding at December 31, 2006 increased significantly by \$51.9 million, or 34.8%, to \$201.4 million at December 31, 2006 from \$149.4 million at December 31, 2005, and increased by \$50.9 million,

or 51.6%, to \$149.4 million at December 31, 2005 from \$98.5 million at December 31, 2004. Total commercial loan commitments (including undisbursed amounts) at December 31, 2006 increased \$90.8 million or 36.4% to \$340.2 from \$249.4 million at December 31, 2005 while the rate of credit utilization remained about the same level during 2006 and 2005 at 58.6% and 59.9%, respectively. We believe that this steady level of utilization of commercial loans is due to the consistent demand by our larger distribution customers to increase their working capital requirements. Subject to market conditions and interest rates, we intend to expand our commercial loans in the future through enhanced marketing efforts and expansion of our branch network.

Trade finance loans increased \$9.4 million or 12.2% during 2006 to \$86.1 million from to \$76.7 million at December 31, 2005, and grew in 2005 by \$30.7 million, or 66.9%, from \$45.9 million at December 31, 2004. We believe this increase is due to higher utilization of existing credit lines as well as the addition of new customers comparable to that of our commercial loan customers as well as our continued caution in the application of our underwriting standards. It is possible that if the U.S. dollar continues to weaken against other foreign currencies, as it did during 2006, the cost of imported goods will increase, which could have an adverse impact on some of our customers who import goods for resale in the United States.

Leases receivable and other loans declined during 2006 by \$554,000, or 49.6%, to \$564,000 at December 31, 2006 and declined during 2005 by \$21,000, or 2.1%, to \$1.0 million from December 31, 2004. The decrease in 2006 is attributed to a decrease in our overdraft balances due to its nature which fluctuate daily and are included in other loans.

#### *Non-Performing Assets*

Generally, loans and leases are placed on non-accrual status when they become 90 days or more past due or at such earlier time as management determines timely recognition of interest to be in doubt. Accrual of interest is discontinued on a loan or lease when management believes, after considering economic and business conditions and collection efforts, that the borrower's financial condition is such that collection of interest is doubtful.

As of December 31, 2006, we had no OREO property outstanding. In 2005 we sold an OREO property that had been generating income for the bank. For the year-ended December 31, 2006, we had no OREO income as compared to \$195,000 of OREO income realized for December 31, 2005 and \$526,000 of OREO income realized for the year-ended December 31, 2004.

We record OREO properties at the lower of the carrying value of the loan or fair market value of the property based on current appraisals, less estimated selling costs.

The following table summarizes the loans and leases for which the accrual of interest has been discontinued and loans and leases more than 90 days past due and still accruing interest, including those loans and leases that have been restructured, and OREO:

	Year Ended December 31,				
	2006	2005	2004	2003	2002
	(Dollars in thousands)				
Non-accrual loans and leases, not restructured . . . . .	1,120	\$ —	\$ 382	\$1,000	\$ 6,235
Accruing loans and leases past due 90 days or more . . . . .	—	—	—	—	—
Restructured loans and leases . . . . .	—	—	—	—	—
Total non-performing loans (NPLs) . . . . .	1,120	—	382	1,000 <sup>(1)</sup>	6,235 <sup>(1)</sup>
OREO . . . . .	—	—	8,258 <sup>(2)</sup>	8,258 <sup>(2)</sup>	8,188 <sup>(2)</sup>
Total non-performing assets (NPAs) . . . . .	1,120	\$ —	\$8,641	\$9,258	\$14,423
Selected ratios:					
NPLs to total loans and leases held for investment . . . . .	0.11%	0.00%	0.06%	0.20%	1.39%
NPAs to total assets . . . . .	0.08%	0.00%	0.95%	1.22%	2.04%

(1) Represents the UAL Leveraged Lease.

(2) Represents 60 Federal.

The amount of interest income that we would have recorded on the non-accrual and impaired loans and leases had the loans and leases been current totaled \$41,000, \$0, \$15,000, \$132,000 and \$26,000 for 2006, 2005, 2004, 2003 and 2002 respectively. All payments received on loans classified as non-accrual are applied first to principal.

### ***Impaired Loans and Leases***

Impaired loans and leases are commercial, commercial real-estate, other real-estate related and individually significant mortgage and consumer loans and leases for which it is probable that we will not be able to collect all amounts due according to the contractual terms of the loan or lease agreement. The category of impaired loans and leases is not comparable with the category of non-accrual loans and leases, although the two categories overlap. Non-accrual loans and leases include impaired loans and leases that are not reviewed on an individual basis for impairment. Management may choose to place a loan or lease on non-accrual status due to payment delinquency or uncertain collectibility, while not classifying the loan or lease as impaired if it is probable that we will collect all amounts due in accordance with the original contractual terms of the loan or lease or the loan.

In determining whether or not a loan or lease is impaired, we apply our normal loan and lease review procedures on a case-by-case basis taking into consideration the circumstances surrounding the loan or lease and borrower, including the collateral value, the reasons for the delay, the borrower's prior payment record, the amount of the shortfall in relation to the principal and interest owed and the length of the delay. We measure impairment on a loan-by-loan basis using either the present value of expected future cash flows discounted at the loan's or lease's effective interest rate or at the fair value of the collateral if the loan or lease is collateral dependent, less estimated selling costs. Loans or leases for which an insignificant shortfall in amount of payments is anticipated, but where we expect to collect all amounts due, are not considered impaired.

We had \$1.1 million, \$800,000 and \$382,000 of impaired loans or leases at December 31, 2006, 2005, and 2004 respectively. The total allowance for loan and lease losses related to these loans and leases were \$11,000, \$300,000 and \$57,000 at December 31, 2006, 2005 and 2004, respectively.

At December 31, 2006, we had \$1.1 million of outstanding loans disclosed above as non-accrual loans which management questions the ability of the borrower to comply with the present loan repayment terms. These two (2) loans are secured by real estate and have collateral values well in excess of the outstanding loan amount.

### ***Allowance for Loan and Lease Losses***

The allowance for loan and lease losses is maintained at a level which, in management's judgment, is adequate to absorb loan and lease losses inherent in the loan and lease portfolio. The amount of the allowance is based on management's evaluation of the collectibility of the loan and lease portfolio and that evaluation is based on historical loss experience and other significant factors. These other significant factors include the level and trends in delinquent, non-accrual and adversely classified loans and leases, trends in volume and terms of loans and leases, levels and trends in credit concentrations, effects of changes in underwriting standards, policies, procedures and practices, national and local economic trends and conditions, changes in capabilities and experience of lending management and staff and other external factors including industry conditions, competition and regulatory requirements.

We must maintain an adequate allowance for loan and lease losses, or ALLL, based on a comprehensive methodology that assesses the probable losses inherent in the loan portfolio. The appropriateness of both the methodology and the adequacy of the ALLL are the responsibility of the Chief Credit Officer under the supervision of our board of directors. Each quarter end, our Chief Credit Officer must assess the methodology and adequacy of the ALLL, representing that they comply with applicable banking regulations and generally accepted accounting principles.

Like all financial institutions, we maintain an ALLL based on a number of quantitative and qualitative factors, including those discussed above. Provisions for loan and lease losses are provided on both a specific and general basis. Specific allowances are provided for specific credits for which the expected/anticipated loss is measurable. General valuation allowances are based on the historical loss experience in those categories covering the most recent eight quarters, as well as factors noted above.

The table below summarizes loans and leases, average loans and leases, non-performing loans and leases and changes in the allowance for loan and lease losses arising from loan and lease losses and additions to the allowance from provisions charged to operating expense:

### Allowance For Loan and Lease Loss History

	Year Ended December 31,				
	2006	2005	2004	2003	2002
	(Dollars in thousands)				
Allowance for loan losses:					
Balance at beginning of period	\$ 8,939	\$ 6,724	\$ 6,168	\$ 9,257	\$ 4,906
Actual charge-offs:					
Commercial	273	5	103	39	1,947
Trade finance	390	—	—	74	653
Construction	—	—	—	—	—
Real estate (mini-perm)	—	—	—	—	549
Leveraged lease	—	—	1,000	5,232	3,084
Other (credit card)	—	—	0	0	1
Total charge-offs	663	5	1,103	5,345	6,234
Less recoveries:					
Commercial	—	110	106	45	16
Trade finance	—	—	—	111	60
Construction	—	—	—	—	—
Real estate (mini-perm)	—	—	—	—	363
Leveraged leases	—	—	—	—	—
Other	—	—	3	—	—
Total recoveries	—	110	109	156	439
Net loans charged-off (recovered)	663	(105)	994	5,189	5,795
Provision for loan losses	1,960	2,110	1,550	2,100	10,146
Balance at end of period	\$ 10,236	\$ 8,939	\$ 6,724	\$ 6,168	\$ 9,257
Total loans at end of period	997,317	771,143	615,961	504,053	448,512
Average total loans and leases	867,674	692,320	541,402	466,793	418,845
Non-performing loans and leases	1,120	—	382	1,000	6,418
Selected ratios:					
Net charge-offs (recoveries) to average loans and leases	0.08%	(0.02)%	0.18%	1.11%	1.38%
Provision for allowance for loan and lease losses to average loans and leases	0.23%	0.30%	0.29%	0.45%	2.42%
Allowance for loan and lease losses to loans and leases at end of period	1.03%	1.16%	1.09%	1.22%	2.06%
Allowance for loan and lease losses to non-performing loans and leases	913.93%	n.m.	1758.64%	616.8%	144.23%

The allowance for loan and lease losses of \$10.2 million at December 31, 2006, represented 1.03% of total loans and leases, net of deferred loan fees and costs and 913.93% of non-performing loans and leases. At December 31, 2005 the allowance for loan and lease losses totaled \$8.9 million or 1.16% of total loans and leases, net of deferred fees and costs. At December 31, 2004, the allowance for loan and lease losses totaled \$6.7 million, or 1.09% of total loans and leases, net of deferred fees, and 1758.6% of non-performing loans and leases as of that date. Net charge-offs (recoveries) to average loans and leases were 0.08% for year-ended December 31, 2006 compared to (0.02)% for the year-ended December 31, 2005. See "Critical Accounting Policies," and Note 3 of the "Notes to Financial Statements."

In allocating our allowance for loan and lease losses, management has considered the credit risk in the various loan and lease categories in our portfolio. As such, the allocations of the allowance for loan and lease losses are based upon average historical net loan and lease loss experience and the other factors discussed above. While every effort has been made to allocate the allowance to specific categories of loans, management believes that any allocation of the allowance for loan and lease losses into loan categories lends an appearance of precision that does not exist.

The following table reflects management's allocation of the allowance and the percent of loans in each category to total loans and leases as of each of the following dates:

	At December 31,									
	2006		2005		2004		2003		2002	
	Allocation of the Allowance	Percent of Loans in Each Category in Total Loans	Allocation of the Allowance	Percent of Loans in Each Category in Total Loans	Allocation of the Allowance	Percent of Loans in Each Category in Total Loans	Allocation of the Allowance	Percent of Loans in Each Category in Total Loans	Allocation of the Allowance	Percent of Loans in Each Category in Total Loans
	(Dollars in thousands)									
Commercial* . . . . .	\$ 2,262	20.2%	\$2,312	19.4%	\$1,511	16.0%	\$1,390	23.3%	\$1,392	24.2%
Trade finance* . . . . .	897	8.6	1,231	9.9	645	7.5	438	7.5	556	7.0
Real estate construction* . . . . .	3,169	27.2	1,837	22.3	1,064	18.2	508	18.8	623	19.1
Real estate (mini-perm)* . . . . .	3,822	43.9	3,513	48.2	3,456	58.1	2,132	49.8	1,662	47.9
Lease . . . . .	3	0.0	5	0.1	7	0.1	861	0.4	4,380	1.6
Other . . . . .	4	0.1	6	0.1	4	0.1	12	0.2	12	0.2
Unallocated . . . . .	79	0.0	35	0.0	37	0.0	827	0.0	632	0.0
Total . . . . .	<u>\$10,236</u>	<u>100.0%</u>	<u>\$8,939</u>	<u>100.0%</u>	<u>\$6,724</u>	<u>100.0%</u>	<u>\$6,168</u>	<u>100.0%</u>	<u>\$9,257</u>	<u>100.0%</u>

\* These categories include watch list credits

As noted above, we reserved for the UAL Leveraged Lease in 2002 and 2003 and wrote the remaining balance off in 2003 and 2004.

***Allowance for Losses Related to Undisbursed Loan and Lease Commitments***

We maintain a reserve for undisbursed loan and lease commitments. Management estimates the amount of probable losses by applying the loss factors used in our allowance for loan and lease loss methodology to our estimate of the expected usage of undisbursed commitments for each loan and lease type. The allowance for undisbursed loan and lease commitments totaled \$70,000, \$110,000, \$200 and \$102,000 at December 31, 2006, 2005, 2004 and 2003 respectively.

***Investment Securities Available for sale***

Our portfolio of investment securities consists primarily of U.S. Treasury securities, U.S. government agencies securities, investment grade corporate notes, mortgage-backed securities, municipal bonds and FHLMC

preferred stock, which is included in other securities. We carry our entire securities portfolio as available-for-sale securities. We invest in securities to generate interest income and to maintain a liquid source of funding for our lending and other operations, including withdrawals of deposits. While we do not engage in active trading in our investment securities portfolio, we have realized and intend to realize gains from sales of selected securities primarily in response to changes in interest rates. At December 31, 2006, investment securities available-for-sale with a carrying value of \$157.8 million were pledged to secure public deposits.

The carrying value of our investment securities at December 31, 2006 totaled \$198.7 million compared to \$162.9 million at December 31, 2005. During 2006, our investment securities portfolio increased which reflects continuing growth in our deposits and a strategic decision to maintain liquidity. The carrying value of our portfolio of investment securities at December 31, 2006, 2005 and 2004 was as follows:

	Estimated Market Value At December 31,		
	2006	2005	2004
	(In thousands)		
U.S. Government agencies	\$142,106	\$ 85,238	\$ 71,027
Corporate notes	16,657	36,463	53,913
Mortgage-backed securities	17,200	16,003	12,713
Municipal securities	19,308	19,387	19,111
Other securities	3,418	5,844	7,871
Total securities available-for-sale	<u>\$198,689</u>	<u>\$162,935</u>	<u>\$164,635</u>

The following table shows the maturities of investment securities at December 31, 2006, and the weighted average yields of such securities (municipal security yields are on a tax-equivalent basis):

	At December 31, 2006									
	Within One Year		After One Year but within Five Years		After Five Years but within Ten Years		After Ten Years		Total	
	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield
	(Dollars in thousands)									
U.S. Government Agencies	\$117,284	4.93%	\$23,470	5.58%	\$1,352	3.85%	\$ —	— %	\$142,106	5.03%
Corporate notes	—	—	3,098	6.07	2,000	7.25	11,558	6.67	16,656	6.63
Mortgage-backed securities	129	3.35	—	—	—	—	17,071	5.89	17,200	5.87
Municipal securities	—	—	—	—	—	—	19,309	5.37	19,309	5.37
Other securities	858	5.51	—	—	—	—	2,560	6.48	3,418	6.24
Total securities available-for-sale	<u>\$118,271</u>	<u>4.89%</u>	<u>\$26,568</u>	<u>5.64%</u>	<u>\$3,352</u>	<u>5.88%</u>	<u>\$50,498</u>	<u>5.90%</u>	<u>\$198,689</u>	<u>5.26%</u>

The following table shows the maturities of investment securities at December 31, 2005, and the weighted average yields of such securities (municipal security yields are on a tax-equivalent basis):

	At December 31, 2005									
	Within One Year		After One Year but within Five Years		After Five Years but within Ten Years		After Ten Years		Total	
	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield
	(Dollars in thousands)									
U.S. Government Agencies	\$61,724	3.24%	\$18,219	3.64%	\$5,295	4.17%	\$ —	— %	\$ 85,238	3.38%
Corporate notes	17,831	4.39	1,034	6.12	3,814	6.64	13,784	6.32	36,463	5.40
Mortgage-backed securities	—	—	202	3.39	—	—	15,801	3.91	16,003	3.90
Municipal securities	—	—	—	—	—	—	19,387	5.58	19,387	5.58
Other securities	3,447	4.13	—	—	—	—	2,397	5.00	5,844	4.49
Total securities available-for-sale	<u>\$83,002</u>	<u>3.35%</u>	<u>\$19,455</u>	<u>3.77%</u>	<u>\$9,109</u>	<u>5.20%</u>	<u>\$51,369</u>	<u>5.24%</u>	<u>\$162,935</u>	<u>4.10%</u>



Additional information concerning investment securities is provided in Note 4 of the “Notes to Financial Statements” in this annual report.

**Deposits**

Total deposits were \$1.2 billion at December 31, 2006 compared to \$975.5 million at December 31, 2005. Noninterest-bearing demand deposits increased to \$224.9 million at December 31, 2006 compared to \$211.9 million at December 31, 2005. The ratio of noninterest-bearing deposits to total deposits was 19.4% at December 31, 2006 and 21.7% at December 31, 2005. Interest-bearing deposits are comprised of interest-bearing demand deposits, money market accounts, regular savings accounts, time deposits of under \$100,000 and time deposits of \$100,000 or more.

The following table shows the average amount and average rate paid on the categories of deposits for each of the periods indicated:

	Year Ended December 31,					
	2006		2005		2004	
	Average Balance	Average Rate	Average Balance	Average Rate	Average Balance	Average Rate
	(Dollars in thousands)					
Noninterest-bearing deposits . . . . .	\$ 207,685	0.00%	\$184,102	0.00%	\$157,688	0.00%
Interest-bearing demand deposits . . . . .	26,353	1.20	26,757	0.56	26,064	0.31
Money market . . . . .	106,962	2.00	121,444	1.07	118,039	0.62
Savings . . . . .	67,317	3.61	38,346	1.33	24,311	0.31
Time certificates of deposit . . . . .	597,504	4.30	493,510	2.76	409,894	1.51
Total . . . . .	<u>\$1,005,821</u>	<u>3.83%</u>	<u>\$864,159</u>	<u>2.29%</u>	<u>\$735,996</u>	<u>0.96%</u>

Average total deposits increased steadily through 2006. The increase in average total deposits for 2006 was primarily driven by an increase of \$104 million in time certificates of deposit and \$24 million in noninterest bearing demand deposits. Additional information concerning deposits is provided in Note 5 of the “Notes to Financial Statements” in the annual report.

The largest component of our deposits has been, and in the near term is likely to be, time certificates of deposit of \$100,000 or more. We market and receive time certificates of deposit from our existing and new high net worth customers, especially from the Chinese communities within our branch network. While we do not attempt to be a market leader in offered interest rates, we attempt to offer competitive rates on these time certificates of deposit within a range offered by other banks with which we compete.

The following table shows the maturities of time certificates of deposit and other time deposits of \$100,000 or more at December 31, 2006 and 2005:

	At December 31,	
	2006	2005
	(In thousands)	
Three months or less . . . . .	\$407,432	\$299,799
Over three months through six months . . . . .	187,890	99,870
Over six months through twelve months . . . . .	107,466	155,648
Over twelve months . . . . .	9,469	5,971
Total . . . . .	<u>\$712,257</u>	<u>\$561,288</u>

**Capital Resources**

Current risk-based regulatory capital standards generally require banks to maintain a ratio of “core” or “Tier 1” capital (consisting principally of common equity) to risk-weighted assets of at least 4%, a ratio of Tier 1 capital to adjusted total assets (leverage ratio) of at least 4% and a ratio of total capital (which includes Tier 1 capital plus certain forms of subordinated debt, a portion of the allowance for loan and lease losses and preferred stock) to risk-weighted assets of at least 8%. Risk-weighted assets are calculated by multiplying the balance in each category of assets by a risk factor, which ranges from zero for cash assets and certain government obligations to 100% for some types of loans, and adding the products together.

Our goal is to exceed the minimum regulatory capital requirements for well-capitalized institutions. At December 31, 2006, our capital ratios were above the minimum requirements for well-capitalized institutions. In the future, we intend to make minor adjustments and increase our investment securities portfolio, such as reducing our investments in corporate notes, which are 100% risk weighted assets, and increasing our investments in mortgage-backed securities or U.S. agency notes, which are generally 20% risk weighted assets. In addition, in the future, we intend to originate credit lines when possible for 365 days or less, which are 0% risk weighted assets, instead of 366 days or more, which are 50% risk weighted assets. We believe that our existing capital will be sufficient for the foreseeable future to satisfy minimum regulatory capital requirements, including as those increase due to our presently anticipated growth in our loan portfolio.

	<u>At December 31, 2006</u>	<u>At December 31, 2005</u>
<b>Leverage Ratio</b>		
Preferred Bank . . . . .	11.50%	11.63%
Minimum requirement for “Well-Capitalized” institution . . . . .	5.00%	5.00%
Minimum regulatory requirement . . . . .	4.00%	4.00%
<b>Tier 1 Risk-Based Capital Ratio</b>		
Preferred Bank . . . . .	11.52%	12.59%
Minimum requirement for “Well-Capitalized” institution . . . . .	6.00%	6.00%
Minimum regulatory requirement . . . . .	4.00%	4.00%
<b>Total Risk-Based Capital Ratio</b>		
Preferred Bank . . . . .	12.33%	13.51%
Minimum requirement for “Well-Capitalized” institution . . . . .	10.00%	10.00%
Minimum regulatory requirement . . . . .	8.00%	8.00%

**Contractual Obligations and Off-Balance Sheet Arrangements**

The following table presents our contractual cash obligations, excluding deposits, as of December 31, 2006:

<u>Contractual Obligations<sup>(1)</sup></u>	<u>Amount of Commitment Expiring Per Period</u>				
	<u>Total Amounts Committed</u>	<u>Less Than 1 Year</u>	<u>1-3 Years</u>	<u>3-5 Years</u>	<u>After 5 Years</u>
	(In thousands)				
FHLB Advances . . . . .	\$20,000	\$ —	\$12,000	\$8,000	\$ —
Operating Lease Obligations . . . . .	7,349	1,761	2,791	1,593	1,204
Total . . . . .	<u>\$27,349</u>	<u>\$1,761</u>	<u>\$14,791</u>	<u>\$9,593</u>	<u>\$1,204</u>

(1) Contractual obligations do not include interest

In the normal course of business, we enter into off-balance sheet arrangements consisting of commitments to extend credit, to fund commercial letters of credit and standby letters of credit. The following table presents these off-balance sheet arrangements at December 31, 2006:

<u>Off-balance sheet arrangements</u>	<u>Amount of off-balance sheet Expiring Per Period</u>				
	<u>Total Amounts Committed</u>	<u>Less Than 1 Year</u>	<u>1-3 Years</u>	<u>3-5 Years</u>	<u>After 5 Years</u>
			(In thousands)		
Commitments to extend credit . . . . .	\$496,850	\$349,399	\$140,547	\$5,438	\$1,466
Commercial letters of credit . . . . .	3,860	3,860	—	—	—
Standby letter of credit . . . . .	11,666	10,495	1,171	—	—
Total . . . . .	<u>\$512,376</u>	<u>\$363,754</u>	<u>\$141,718</u>	<u>\$5,438</u>	<u>\$1,466</u>

### Liquidity

Based on our existing business plan, we believe that our level of liquid assets is sufficient to meet our current and presently anticipated funding needs. We rely on deposits as the principal source of funds and, therefore, must be in a position to service depositors' needs as they arise. We attempt to maintain a loan-to-deposit ratio below approximately 95%. Our loan-to-deposit ratios were 85% at December 31, 2006 and 78% at December 31, 2005.

Borrowings from the Federal Home Loan Bank of San Francisco, or FHLBSF, is another source of funding for our loan and investment activities. At December 31, 2006, we could borrow up to \$81.7 million with collateral of specifically identified loans and securities. We intend to explore the feasibility of utilizing the FHLBSF as a source of funding to a greater extent than we have in the past. At December 31, 2006, our borrowing line with the FHLBSF was \$101.7 million. As an additional condition of borrowing from the FHLBSF, we are required to purchase FHLB stock. For the year ended December 31, 2006, the Bank was required to purchase the greater of; \$3,512,000 of FHLB stock based on the volume of "membership assets" as defined by the FHLB, or \$940,000 in FHLB stock based on 4.7% of outstanding borrowings with the FHLB. At December 31, 2006, the Bank held \$3,683,000 in FHLB stock.

We also attempt to maintain a liquidity ratio (liquid assets, including cash and due from banks, federal funds sold and investment securities not pledged as collateral expressed as a percentage of total deposits) above approximately 18%. Our liquidity ratios were 19% at December 31, 2006 and 30% at December 31, 2005. The decrease in our liquidity ratio from the 2005 level was attributed primarily to a 19% growth of deposits during 2006. We believe that in the event the level of liquid assets (our primary liquidity) does not meet our liquidity needs, other available sources of liquid assets (our secondary liquidity), including the purchase of federal funds, sales of securities under agreements to repurchase, sales of unpledged investment securities or loans, utilizing the discount window borrowings from the Federal Reserve Bank (where we maintain \$17.5 million in collateralized borrowing capacity) and the FHLBSF, could be employed to meet those funding needs.

### Quantitative and Qualitative Disclosures About Market Risk

Market risk is the risk of loss in a financial instrument arising from adverse changes in market prices and rates, foreign currency exchange rates, commodity prices and equity prices. Our market risk arises primarily from interest rate risk inherent in our lending and deposit taking activities. To that end, management actively monitors and manages our interest rate risk exposure. We do not have any market risk sensitive instruments entered into for trading purposes. We manage our interest rate sensitivity by matching the re-pricing opportunities on our earning assets to those on our funding liabilities. Management uses various asset/liability strategies to manage the re-pricing characteristics of our assets and liabilities designed to ensure that exposure to interest rate fluctuations is limited and within our guidelines of acceptable levels of risk-taking. Hedging strategies, including the terms

and pricing of loans and deposits and managing the deployment of our securities, are used to reduce mismatches in interest rate re-pricing opportunities of portfolio assets and their funding sources.

Interest rate risk is addressed by our Asset Liability Management Committee, or the ALCO, which is comprised of the Chief Executive Officer, Chief Financial Officer and members of the board of directors. The ALCO monitors interest rate risk by analyzing the potential impact on the net portfolio of equity value and net interest income from potential changes in interest rates, and considers the impact of alternative strategies or changes in balance sheet structure. The ALCO manages our balance sheet in part to maintain the potential impact on net portfolio value and net interest income within acceptable ranges despite rate changes in interest rates.

Our exposure to interest rate risk is monitored continuously by senior management and is reviewed by the ALCO at least eight times a year, and at least quarterly by our board of directors. Interest rate risk exposure is measured using interest rate sensitivity analysis to determine our change in net portfolio value and net interest income in the event of hypothetical changes in interest rates. If potential changes to net portfolio value and net interest income resulting from our analysis of hypothetical interest rate changes are not within board-approved limits, the board may direct management to adjust the asset and liability mix to bring interest rate risk within board-approved limits. This analysis of hypothetical interest rate changes is performed on a monthly basis by a third party venter utilizing detailed data that we provide to them.

### ***Market Value of Portfolio Equity***

We measure the impact of market interest rate changes on the net present value of estimated cash flows from our assets and liabilities defined as market value of portfolio equity, using a simulation model. This simulation model assesses the changes in the market value of interest rate sensitive financial instruments that would occur in response to an instantaneous and sustained increase or decrease in market interest rates.

The following table presents forecasted changes in net portfolio value using a base market rate and the estimated change to the base scenario given an immediate and sustained upward and downward movement in interest rates of 100 and 200 basis points at December 31, 2006.

### **Market Value of Portfolio Equity**

<u>Interest Rate Scenario</u>	<u>Market Value</u> (Dollars in thousands)	<u>Percentage Change from Base</u>	<u>Percentage of Total Assets</u>	<u>Percentage of Portfolio Equity Book Value</u>
Up 200 basis points . . . . .	\$134,850	(4.73)%	10.00%	92.41%
Up 100 basis points . . . . .	\$137,954	(2.54)	10.23	94.53
BASE . . . . .	\$141,544	—	10.49	96.99
Down 100 basis points . . . . .	\$143,435	1.34	10.63	98.29
Down 200 basis points . . . . .	\$142,554	0.71	10.57	97.69

The computation of prospective effects of hypothetical interest rate changes are based on numerous assumptions, including relative levels of market interest rates, asset prepayments and deposit decay, and should not be relied upon as indicative of actual results. Further, the computations do not contemplate any actions we may undertake in response to changes in interest rates. Actual amounts may differ from the projections set forth above should market conditions vary from the underlying assumptions.

### ***Net Interest Income***

In order to measure interest rate risk at December 31, 2006, we used a simulation model to project changes in net interest income that result from forecasted changes in interest rates. This analysis calculates the difference between net interest income forecasted using a rising and a falling interest rate scenario and a net interest income

forecast using a base market interest rate derived from the current treasury yield curve. The income simulation model includes various assumptions regarding the re-pricing relationships for each of our products. Many of our assets are floating rate loans, which are assumed to re-price immediately, and to the same extent as the change in market rates according to their contracted index. Some loans and investment vehicles include the opportunity of prepayment (embedded options), and accordingly the simulation model uses national indexes to estimate these prepayments and reinvest their proceeds at current yields. Our non-term deposit products re-price more slowly, usually changing less than the change in market rates and at our discretion.

This analysis indicates the impact of changes in net interest income for the given set of rate changes and assumptions. It assumes no growth in the balance sheet and that its structure will remain similar to the structure at year end. It does not account for all factors that impact this analysis, including changes by management to mitigate the impact of interest rate changes or secondary impacts such as changes to our credit risk profile as interest rates change. Furthermore, loan prepayment rate estimates and spread relationships change regularly. Interest rate changes create changes in actual loan prepayment rates that will differ from the market estimates incorporated in this analysis. Changes that vary significantly from the assumptions may have significant effects on our net interest income.

For the rising and falling interest rate scenarios, the base market interest rate forecast was increased or decreased on an instantaneous and sustained basis.

#### Sensitivity of Net Interest Income December 31, 2006

Interest Rate Scenario	Adjusted Net Interest Income	Percentage Change from Base	Net Interest Margin Percent	Net Interest Margin Change (in basis points)
	(Dollars in thousands)			
Up 200 basis points .....	\$78,642	14.76%	6.07%	78
Up 100 basis points .....	73,570	7.35	5.67	38
BASE .....	68,530	—	5.29	—
Down 100 basis points .....	67,950	(0.85)	5.24	(5)
Down 200 basis points .....	67,209	(1.93)	5.18	(11)

At December 31, 2006, we had \$1.2 billion in assets and \$934.9 million in liabilities re-pricing within one year. This indicates that approximately \$275.7 million more of our interest rate sensitive assets than our interest rate sensitive liabilities will change to the then current rate (changes occur due to the instruments being at a variable rate or because the maturity of the instrument requires its replacement at the then current rate). The ratio of interest-earning assets to interest-bearing liabilities maturing or re-pricing within one year at December 31, 2006 is 129.5%. In theory, this analysis indicates that at December 31, 2006, if interest rates were to increase, the gap would tend to result in a higher net interest margin. However, changes in the mix of earning assets or supporting liabilities can either increase or decrease the net interest margin without affecting interest rate sensitivity. In addition, the interest rate spread between an asset and its supporting liability can vary significantly while the timing of re-pricing of both the asset and its supporting liability can remain the same, thus impacting net interest income. This characteristic is referred to as basis risk, and generally relates to the re-pricing characteristics of short-term funding sources such as certificates of deposit.

#### **Recently Issued Accounting Pronouncements**

In February 2006, the Financial Accounting Standards Board (“FASB”) issued SFAS No.155, “*Accounting for Certain Hybrid Financial Instruments, an amendment of FASB Statements No. 133 and SFAS No. 140*” (“SFAS No. 155”). This Statement:

- permits fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation;
- clarifies which interest-only strips and principal-only strips are not subject to SFAS No. 133;

- establishes a requirement to evaluate interests in securitized financial assets to identify interests that are freestanding derivatives or hybrid financial instruments that contain an embedded derivative requiring bifurcation;
- clarifies that concentrations of credit risks in the form of subordinations are not embedded derivatives; and amends SFAS No. 140 to eliminate the prohibition on a Qualified Special Purpose Entity from holding a derivative financial instrument that pertains to a beneficial interest other than another derivative financial instrument.

SFAS No. 155 is effective for all financial instruments acquired or issued after the beginning of an entity's first fiscal year that begins after September 15, 2006. Early adoption of this statement is allowed. We have not determined the financial impact of the adoption of SFAS No. 155

In March 2006, the FASB issued SFAS No. 156, "*Accounting for Servicing of Financial Assets*," which amends the guidance in SFAS No. 140. SFAS No. 156 requires that an entity separately recognize a servicing asset or a servicing liability when it undertakes an obligation to service a financial asset under a servicing contract in certain situations. Such servicing assets or servicing liabilities are required to be measured initially at fair value, if practicable. SFAS No. 156 also allows an entity to measure its servicing assets and servicing liabilities subsequently using either the amortization method, which existed under SFAS No. 140, or the fair value measurement method. SFAS No. 156 will be effective in the fiscal year beginning January 1, 2007. We do not expect the adoption of SFAS No. 156 to have a material impact on our financial condition or results of operations.

In July 2006, the FASB issued FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes" ("FIN 48"). FIN 48 is an interpretation of FAS Statement No. 109, "Accounting for Income Taxes." The Interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return and requires additional disclosures. Under the new guidance, recognition is based upon whether or not a company determines that it is more likely than not that a tax position will be sustained upon examination based upon the technical merits of the position. In evaluating the more-likely-than-not recognition threshold, a company should presume the tax position will be subject to examination by a taxing authority with full knowledge of all relevant information. If the recognition threshold is met, then the tax position is measured at the largest amount of benefit that is more than 50% likely of being realized upon ultimate settlement. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. The Interpretation is effective for fiscal years beginning after December 15, 2006. While the effect of FIN 48 will depend somewhat upon the implementation guidance, the company expects the transition effects of this standard to be not material.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* ("SFAS 157"). The Statement provides a revised definition of fair value and guidance on the methods used to measure fair value. The Statement also expands financial statement disclosure requirements for fair value information. The Statement establishes a fair value hierarchy that distinguishes between assumptions based on market data from independent sources ("observable inputs") and a reporting entity's internal assumptions based upon the best information available when external market data is limited or unavailable ("unobservable inputs"). The fair value hierarchy in FAS 157 prioritizes inputs within three levels. Quoted prices in active markets have the highest priority (Level 1) followed by observable inputs other than quoted prices (Level 2) and unobservable inputs having the lowest priority (Level 3). The Statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, with earlier application allowed for entities that have not issued financial statements in the fiscal year of adoption. The Company is currently assessing the impact of SFAS No.157 on its financial condition, results of operations or cash flows.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*. This Statement permits companies to choose to measure many financial instruments and



certain other items at fair value. Once a company chooses to report an item at fair value, changes in fair value would be reported in earnings at each reporting date. This Statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, with earlier application allowed for entities that have not issued financial statements in the fiscal year of adoption. We are presently evaluating this Statement and have not yet determined the effect of its adoption on our financial condition, result of operation or cash flow.

In September 2006, the SEC issued Staff Accounting Bulletin (“SAB”) No. 108, “*Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements.*” SAB No. 108 specifies how the carryover or reversal of prior year unrecorded financial statement misstatements should be considered in quantifying a current year misstatement. SAB No. 108 requires an approach that considers the amount by which the current year Statement of Income is misstated (“rollover approach”) and an approach that considers the cumulative amount by which the current year Statement of Financial Condition is misstated (“iron curtain approach”). Prior to the issuance of SAB No. 108, either the rollover or iron curtain approach was acceptable for assessing the materiality of financial statement misstatements so long as one methodology was consistently applied.

Initial application of SAB No. 108 allows registrants to elect not to restate prior periods but to reflect the initial application in their annual financial statements covering the first fiscal year ending after November 15, 2006. The cumulative effect of the initial application should be reported in the carrying amounts of assets and liabilities as of the beginning of that fiscal year and the offsetting adjustment, net of tax, should be made to the opening balance of retained earnings for that year. Registrants are required to disclose the nature and amount of each item, when and how each error being corrected arose, and the fact that the errors were previously considered immaterial. The Company adopted this SAB with no material impact on the Company’s financial statements.

### ***Inflation***

The majority of our assets and liabilities are monetary items held by us, the dollar value of which is not affected by inflation. Only a small portion of total assets is in premises and equipment. The lower inflation rate of recent years has not had the positive impact on us that was felt in many other industries. Our small fixed asset investment minimizes any material effect of asset values and depreciation expenses that may result from fluctuating market values due to inflation. Higher inflation rates may increase operating expenses or have other adverse effects on borrowers of the banks, making collection on extensions of credit more difficult for us. Rates of interest paid or charged generally rise if the marketplace believes inflation rates will increase.

## **ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES OF MARKET RISKS**

For quantitative and qualitative disclosures regarding market risks in our portfolio, see, “Management’s Discussion and Analysis of Financial Condition and Results of Operations—Quantitative and Qualitative Disclosure About Market Risk.”

## **ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA**

The financial statements of the Bank, including the “Report of Independent Registered Public Accounting Firm,” are included in this report immediately following Part IV.

## **ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE**

None.



## **ITEM 9A. CONTROLS AND PROCEDURES**

### **Disclosure Controls and Procedures**

As of December 31, 2006, Preferred Bank carried out an evaluation, under the supervision and with the participation of Preferred Bank management, including Preferred Bank's Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of Preferred Bank disclosure controls and procedures and internal controls over financial reporting pursuant to Securities and Exchange Commission ("SEC") rules. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that:

- Preferred Bank disclosure controls and procedures were effective as of the end of the period covered by this report in timely alerting them to material information relating to Preferred Bank that is required to be included in Preferred Bank periodic SEC filings; and
- Preferred Bank internal controls over financial reporting provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles.
- During the quarter ended December 31, 2006, there have been no significant changes in Preferred Bank internal controls over financial reporting or in other factors that could significantly affect these controls subsequent to the evaluation date.
- Disclosure controls and procedures are defined in SEC rules as controls and other procedures designed to ensure that information required to be disclosed in Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms. Preferred Bank disclosure controls and procedures were designed to ensure that material information related to Preferred Bank, is made known to management, including the Chief Executive Officer and Chief Financial Officer, in a timely manner.

### **Management's Report on Internal Control Over Financial Reporting**

The Management of Preferred Bank is responsible for establishing and maintaining adequate internal control over financial reporting pursuant to the rules and regulations of the Securities and Exchange Commission. The Bank's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with U.S. generally accepted accounting principles. Internal control over financial reporting includes those written policies and procedures that:

- pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the company;
- provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles;
- provide reasonable assurance that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and
- provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the company's assets that could have a material effect on the consolidated financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Management under the supervision and with the participation of the Bank's principal executive officer and principal financial officer, assessed the effectiveness of the Bank's internal control over financial reporting as of December 31, 2006. Management based this assessment on criteria for effective internal control over financial reporting described in *Internal Control-Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Management's assessment included an evaluation of the design of Preferred Bank's internal control over financial reporting and testing of the operational effectiveness of its internal control over financial reporting. Management reviewed the results of its assessment with the Audit Committee of our Board of Directors.

Based on this assessment, management determined that, as of December 31, 2006, Preferred Bank maintained effective internal control over financial reporting

KPMG LLP, the independent registered public accounting firm that audited the financial statements of Preferred Bank, has issued a report on management's assessment of the Bank's internal control over financial reporting as of December 31, 2006. The report expresses unqualified opinions on Management's assessment and on the effectiveness of Preferred Bank's internal control over financial reporting as of December 31, 2006

## Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders  
Preferred Bank:

We have audited management's assessment, included in the accompanying Management's Report on Internal Control Over Financial Reporting, that Preferred Bank (the Bank) maintained effective internal control over financial reporting as of December 31, 2006, based on criteria established in *Internal Control-Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Bank's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the Bank's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assessment that the Bank maintained effective internal control over financial reporting as of December 31, 2006, is fairly stated, in all material respects, based on criteria established in *Internal Control-Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Also, in our opinion, the Bank maintained, in all material respects, effective internal control over financial reporting as of December 31, 2006, based on criteria established in *Internal Control-Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the statements of financial condition of Preferred Bank as of December 31, 2006 and 2005, and the related statements of income and comprehensive income, changes in stockholders' equity and cash flows for each of the years in the three-year period ended December 31, 2006, and our report dated March 29, 2007 expressed an unqualified opinion on those financial statements.

Los Angeles, California  
March 29, 2007

**ITEM 9B. OTHER INFORMATION**

On January 12, 2007 we submitted Form 4 “Statement of Changes in Beneficial Ownership of Securities” as a late filing for disposal of securities with a transaction date of November 28, 2006. The beneficial owner of the subject securities is our Chairman, President and CEO Mr. Li Yu.

## PART III

### ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT

Information concerning directors and executive officers of the Bank, to the extent not included under “Item 1 under the heading “*Executive Officers of the Bank*” appearing at the end of Part I of this report, will appear in the Bank’s definitive proxy statement for the 2006 Annual Meeting of Shareholders (the “2006 Proxy Statement”), and such information either shall be (i) deemed to be incorporated herein by reference from the section entitled “ELECTION OF DIRECTORS,” if filed with the Federal Deposit Insurance Corporation pursuant to Regulation 14A not later than 120 days after the end of the Bank’s most recently completed fiscal year or (ii) included in an amendment to this report filed with the Federal Deposit Insurance Corporation on Form 10-K/A not later than the end of such 120 day period.

#### Code of Ethics

The Bank has adopted a code of ethics that applies to its principal executive officer, principal financial and accounting officer, controller, and persons performing similar functions. The code of ethics is posted on our internet website at [www.preferredbank.com](http://www.preferredbank.com).

### ITEM 11. EXECUTIVE COMPENSATION DISCLOSURE

Information concerning executive compensation will appear in the 2006 Definitive Proxy Statement, and such information either shall be (i) deemed to be incorporated herein by reference from the sections entitled “COMPENSATION OF DIRECTORS” and “COMPENSATION OF EXECUTIVE OFFICERS,” if filed with the Federal Deposit Insurance Corporation pursuant to Regulation 14A not later than 120 days after the end of the Bank’s most recently completed fiscal year or (ii) included in an amendment to this report filed with the Federal Deposit Insurance Corporation on Form 10-K not later than the end of such 120 day period.

In July 2006, the Securities and Exchange Commission adopted a new rules “Executive Compensation Disclosure” that require companies to report more data on executive and director compensation, including the total annual compensation of the principal executive and financial officers, the three other highest paid executive officers, and the Bank’s directors. The adopted rules, which do not differ greatly from what had been proposed in January, also revise the guidance on identifying perquisites and the disclosure requirements for “related person” transactions, officers’ and directors’ equity ownership, director independence, and the functions of board committees. The requirements affect disclosure in proxy statements, annual reports, registration statements, and Form 8-K reports. Effective dates vary, beginning as early as 59 days after the rules are published in the Federal Register. The new rules become effective November 7, 2006. The Bank has adopted the new rules effective December 31, 2006.

### ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

Information concerning security ownership of certain beneficial owners and management and information related to the Bank’s equity compensation plans will appear in the 2006 Proxy Statement, and such information either shall be (i) deemed to be incorporated herein by reference from the sections entitled “BENEFICIAL STOCK OWNERSHIP OF PRINCIPAL SHAREHOLDERS AND MANAGEMENT” and “SECURITIES AUTHORIZED FOR ISSUANCE UNDER EQUITY COMPENSATION PLANS,” if filed with the Federal Deposit Insurance Corporation pursuant to Regulation 14A not later than 120 days after the end of the Bank’s most recently completed fiscal year or (ii) included in an amendment to this report filed with the Federal Deposit Insurance Corporation on Form 10-K/A not later than the end of such 120 day period.

**ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS AND DIRECTOR INDEPENDENCE**

Information concerning certain relationships and related transactions will appear in the 2006 Proxy Statement, and such information either shall be (i) deemed to be incorporated herein by reference from the section entitled “CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS and “DIRECTOR INDEPENDENCE,” if filed with the Federal Deposit Insurance Corporation pursuant to Regulation 14A not later than 120 days after the end of the Bank’s most recently completed fiscal year, or (ii) included in an amendment to this report filed with the Federal Deposit Insurance Corporation on Form 10-K/A not later than the end of such 120 day period.

**ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES**

Information concerning principal accountant fees and services will appear in the 2006 Definitive Proxy Statement, and such information either shall be (i) deemed to be incorporated herein by reference from the section entitled “INDEPENDENT PUBLIC ACCOUNTANTS,” if filed with the Federal Deposit Insurance Corporation pursuant to Regulation 14A not later than 120 days after the end of the Bank’s most recently completed fiscal year or (ii) included in an amendment to this report filed with the Federal Deposit Insurance Corporation on Form 10-K/A not later than the end of such 120 day period.

## PART IV

### ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

#### (a)(1) Financial Statements

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#### (a)(2) Financial statement schedules

Schedules have been omitted because they are not applicable, not material or because the information is included in the consolidated financial statements or the notes thereto.

#### (a)(3) Exhibits

<u>Exhibit No.</u>	<u>Exhibit Description</u>
3.1	Amended and Restated Articles of Incorporation <sup>(1)</sup>
3.2	Amended and Restated Bylaws <sup>(1)</sup>
4.1	Common Stock Certificate <sup>(2)</sup>
10.1	Lease relating to the Bank's principal executive office at 601 S. Figueroa Street, 20th Floor, Los Angeles, California with Mitsui Fudosen (U.S.A.), Inc. <sup>(1)</sup>
10.2	Agreement for Item-Processing Services with Fiserv Solutions, Inc., dated as of July 31, 2002 <sup>(1)</sup>
10.3	Agreement for Data-Processing with Fiserv Solutions, Inc., dated as of May 1, 2003 <sup>(1)</sup>
10.4	Maintenance and Service Agreement, dated August 1, 2003 with Exilcom, Inc. d/b/a Northstar Technologies <sup>(1)</sup>
10.5*	1992 Stock Option Plan <sup>(1)</sup>
10.6*	Management Incentive Bonus Plan <sup>(1)</sup>
10.7*	Deferred Compensation Plan <sup>(1)</sup>
10.8*	Stock Option Gain Deferred Compensation Plan <sup>(1)</sup>
10.9*	2004 Equity Incentive Plan <sup>(1)</sup>
10.10*	Form of Indemnification Agreement for directors and executive officers <sup>(1)</sup>
21.1	Subsidiaries of the Registrant
24.1	Power of Attorney
31.1	Chief Executive Officer Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Chief Financial Officer Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Chief Executive Officer Certification Pursuant to 18 U.S.C. Section 1350, As Adopted Pursuant To Section 906 of the Sarbanes-Oxley Act of 2002
32.2	Chief Financial Officer Certification Pursuant to 18 U.S.C. Section 1350, As Adopted Pursuant To Section 906 of the Sarbanes-Oxley Act of 2002

(1) Incorporated by reference from Registrant's Registration Statement on Form 10 filed with the Federal Deposit Insurance Corporation on January 18, 2005.

(2) Incorporated by reference from Registrant's Registration Statement on Form 10 Amendment No. 1 filed with the Federal Deposit Insurance Corporation on February 2, 2005.

\* Denotes management contract or compensatory plan or arrangement.



## Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders  
Preferred Bank:

We have audited the accompanying statements of financial condition of Preferred Bank (the Bank) as of December 31, 2006 and 2005 and the related statements of income and comprehensive income, changes in stockholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2006. These financial statements are the responsibility of the Bank's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Preferred Bank as of December 31, 2006 and 2005 and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 2006 in conformity with U.S. generally accepted accounting principles.

As discussed in Note 1 to the financial statement, effective January 1, 2006 the Company adopted Statement of Accounting Standards ("SFAS") No. 123(R) Share-Based Payment.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of the Company's internal control over financial reporting as of December 31, 2006, based on criteria established in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), and our report dated March 29, 2007, expressed an unqualified opinion on management's assessment of, and the effective operation of, internal control over financial reporting as of December 31, 2006.

/s/ KPMG LLP

Los Angeles, California  
March 29, 2007

**PREFERRED BANK**  
**Statements of Financial Condition**  
**December 31, 2006 and 2005**  
(In thousands, except for shares)

	<b>2006</b>	<b>2005</b>
<b>Assets</b>		
Cash and due from banks .....	\$ 26,878	\$ 25,123
Federal funds sold .....	103,700	158,300
Cash and cash equivalents .....	130,578	183,423
Securities available-for-sale, at fair value .....	198,689	162,935
Loans and leases .....	997,317	771,143
Less allowance for loan and lease losses .....	(10,236)	(8,939)
Less net deferred loan fees .....	(1,759)	(1,537)
Net loans and leases .....	985,322	760,667
Customers' liability on acceptances .....	268	628
Bank furniture and fixtures, net .....	1,711	1,835
Bank-owned life insurance .....	7,896	7,637
Accrued interest receivable .....	8,633	5,529
Federal Home Loan Bank ("FHLB") stock .....	3,682	3,501
Deferred tax assets .....	9,544	8,675
Other assets .....	2,518	1,890
Total assets .....	\$1,348,841	\$1,136,720
<b>Liabilities and Stockholders' Equity</b>		
<b>Liabilities:</b>		
Deposits:		
Demand .....	\$ 224,982	\$ 211,942
Interest-bearing demand .....	124,094	154,552
Savings .....	100,011	47,685
Time certificates of \$100,000 or more .....	619,110	472,948
Other time certificates .....	93,147	88,340
Total deposits .....	1,161,344	975,467
Acceptances outstanding .....	268	628
Advances from the Federal Home Loan Bank .....	20,000	20,000
Federal funds purchased .....	—	1,500
Accrued interest payable .....	5,272	3,070
Other liabilities .....	16,025	12,209
Total liabilities .....	1,202,909	1,012,874
Commitments and contingencies		
<b>Stockholders' equity:</b>		
Preferred stock. Authorized 5,000,000 shares; no share issued and outstanding at December 31, 2006 and December 31, 2005 .....	—	—
Common stock, no par value. Authorized 100,000,000 shares; issued and outstanding 10,274,632 and 10,037,782 shares at December 31, 2006 and December 31, 2005, respectively <sup>(1)</sup> .....	69,658	67,443
Additional paid-in capital .....	1,502	240
Retained earnings .....	75,219	57,305
Accumulated other comprehensive loss:		
Unrealized loss on securities available-for-sale, net of tax .....	(447)	(1,142)
Total stockholders' equity .....	145,932	123,846
Total liabilities and stockholders' equity .....	\$1,348,841	\$1,136,720

(1) Adjusted to reflect February 2007, 3 for 2 stock split, effected in the form of dividend.

See accompanying notes to financial statements.

**PREFERRED BANK**

**Statements of Income and Comprehensive Income**  
**Years ended December 31, 2006, 2005 and 2004**  
(In thousands, except for shares and net income per share)

	2006	2005	2004
Interest income:			
Loans and leases .....	\$ 77,186	\$ 50,443	\$ 32,048
Investment securities .....	8,699	6,375	5,490
Federal funds sold .....	4,377	3,264	1,105
Total interest income .....	90,262	60,082	38,643
Interest expense:			
Interest-bearing demand .....	2,456	1,453	817
Savings .....	2,427	529	76
Time certificates of \$100,000 or more .....	22,006	11,488	4,985
Other time certificates .....	3,669	2,104	1,211
Federal funds purchased .....	58	11	1
FHLB borrowings .....	808	477	357
Total interest expense .....	31,424	16,062	7,447
Net interest income before provision for credit losses .....	58,838	44,020	31,196
Provision for credit losses .....	1,960	2,110	1,550
Net interest income after provision for credit losses .....	56,878	41,910	29,646
Noninterest income:			
Fees and service charges on deposit accounts .....	1,660	2,297	2,393
Trade finance income .....	777	707	729
BOLI income .....	326	312	316
Net other real estate owned income .....	—	195	526
Gain on sale of securities available-for-sale, net .....	—	—	35
Other income .....	265	356	200
Total noninterest income .....	3,028	3,868	4,199
Noninterest expense:			
Salary and employee benefits .....	12,216	10,252	9,741
Net occupancy expense .....	2,303	2,163	1,826
Business development and promotion expense .....	451	444	250
Professional services .....	1,948	1,534	855
Office supplies and equipment expense .....	943	867	754
Other .....	2,156	2,312	1,913
Total noninterest expense .....	20,017	17,571	15,339
Income before income taxes .....	39,889	28,207	18,506
Income taxes .....	16,538	11,382	7,354
Net income .....	\$ 23,351	\$ 16,825	\$ 11,152
Other comprehensive income:			
Unrealized net gains (losses) on securities available-for-sale .....	1,200	(2,102)	186
Less reclassification adjustments for gains included in net income .....	—	—	(6)
Other comprehensive income (loss), before tax .....	1,200	(2,102)	180
Income taxes related to items of other comprehensive income .....	(505)	881	72
Other comprehensive income (loss), net of tax .....	695	(1,221)	108
Comprehensive income .....	\$ 24,046	\$ 15,604	\$ 11,260
Net income per share <sup>(1)</sup> :			
Basic .....	\$ 2.29	\$ 1.72	\$ 1.35
Diluted .....	2.21	1.65	1.28
Weighted-average common shares outstanding <sup>(1)</sup> :			
Basic .....	10,194,515	9,782,645	8,277,597
Diluted .....	10,556,282	10,195,958	8,713,851
Dividends per share <sup>(1)</sup> .....	\$ 0.53	\$ 0.43	\$ 0.40

(1) Adjusted to reflect February 2007, 3 for 2 stock split, effected in the form of dividend.

See accompanying notes to financial statements.

**PREFERRED BANK**

**Statements of Changes in Stockholders' Equity**  
**Years ended December 31, 2006, 2005 and 2004**  
(In thousands, except for shares and dividends declared per share)

	<u>Common shares outstanding</u>	<u>Common stock</u>	<u>Additional paid-in capital</u>	<u>Retained earnings</u>	<u>Accumulated other comprehensive income (loss)</u>	<u>Total stockholders' equity</u>
Balance at December 31, 2003 . . . . .	8,182,399	\$30,980	29	\$36,756	\$ (29)	\$ 67,736
Cash dividends paid \$0.40 per share . . .	—	—	—	(3,317)	—	(3,317)
Tax benefit—exercise of stock options . . . . .	—	—	206	—	—	206
Stock options exercised . . . . .	148,800	923	—	—	—	923
Net income . . . . .	—	—	—	11,152	—	11,152
Change in unrealized gain on securities available-for-sale, net of taxes . . . . .	—	—	—	—	108	108
Balance at December 31, 2004 . . . . .	8,331,199	31,903	235	44,591	79	76,808
Cash dividends paid \$0.43 per share . . .	—	—	—	(4,111)	—	(4,111)
Tax benefit—exercise of stock options . . . . .	—	—	5	—	—	5
Stock options exercised . . . . .	228,150	1,510	—	—	—	1,510
Initial public offering, net of issuance costs . . . . .	1,478,433	34,030	—	—	—	34,030
Net income . . . . .	—	—	—	16,825	—	16,825
Change in unrealized loss on securities available-for-sale, net of taxes . . . . .	—	—	—	—	(1,221)	(1,221)
Balance at December 31, 2005 . . . . .	10,037,782	67,443	240	57,305	(1,142)	123,846
Cash dividends paid \$0.53 per share . . .	—	—	—	(5,437)	—	(5,437)
Tax benefit—exercise of shared-based payment . . . . .	—	—	510	—	—	510
Stock options exercised . . . . .	236,850	2,215	—	—	—	2,215
Share-based payment . . . . .	—	—	752	—	—	752
Net income . . . . .	—	—	—	23,351	—	23,351
Change in unrealized gain on securities available-for-sale, net of taxes . . . . .	—	—	—	—	695	695
Balance at December 31, 2006 . . . . .	<u>10,274,632</u>	<u>\$69,658</u>	<u>\$1,502</u>	<u>\$75,219</u>	<u>\$ (447)</u>	<u>\$145,932</u>

See accompanying notes to financial statements.

**PREFERRED BANK**  
**Statements of Cash Flows**  
**Years ended December 31, 2006, 2005 and 2004**  
(In thousands)

	<u>2006</u>	<u>2005</u>	<u>2004</u>
Cash flows from operating activities:			
Net income .....	\$ 23,351	\$ 16,825	\$ 11,152
Adjustments to reconcile net income to net cash provided by operating activities:			
Provision for credit losses .....	1,960	2,110	1,550
Amortization of net deferred loan fees .....	(222)	845	(987)
Amortization (accretion) of investment securities discounts and premiums, net .....	(31)	1,366	2,002
Gain on sale of securities available-for-sale .....	—	—	(36)
Depreciation and amortization .....	568	579	492
Other than temporary impairment write down on investment .....	—	—	296
Share-based compensation expense .....	752	—	—
Excess tax benefit from share-based payment arrangement .....	478	5	206
Deferred taxes benefits .....	(1,419)	(1,334)	(6,568)
Decrease (increase) in Bank-Owned Life Insurance, accrued interest receivable and other assets .....	(3,812)	(7,700)	3,718
Increase in accrued expenses and other liabilities .....	6,168	1,980	632
Net cash provided by operating activities .....	<u>27,793</u>	<u>14,676</u>	<u>12,457</u>
Cash flows from investing activities:			
Purchase of securities available-for-sale .....	(155,034)	(67,405)	(96,189)
Matured and called .....	116,494	60,800	73,468
Sales .....	—	—	5,094
Principal collected and stock dividends .....	4,017	4,837	6,779
Proceeds from sale of other real estate owned .....	—	8,258	—
Net increase in loans .....	(226,348)	(156,767)	(110,928)
Purchase of bank premises and equipment .....	(444)	(1,049)	(756)
Net cash used in investing activities .....	<u>(261,315)</u>	<u>(151,326)</u>	<u>(122,532)</u>
Cash flows from financing activities:			
Increase in deposits .....	185,877	173,932	138,722
Proceeds from FHLB borrowings .....	—	16,500	5,000
Repayments of FHLB borrowings .....	(1,500)	(10,000)	(5,000)
Excess tax benefit from share-based payment arrangement .....	(478)	—	—
Net proceeds of stock options exercised .....	2,215	1,510	923
Issuance of common stock, net of issuance costs .....	—	34,030	—
Payment of cash dividends .....	(5,437)	(4,111)	(3,318)
Net cash provided by financing activities .....	<u>180,677</u>	<u>211,861</u>	<u>136,327</u>
Net increase (decrease) in cash and cash equivalents .....	(52,845)	75,211	26,252
Cash and cash equivalents at beginning of year .....	<u>183,423</u>	<u>108,212</u>	<u>81,960</u>
Cash and cash equivalents at end of year .....	<u>\$ 130,578</u>	<u>\$ 183,423</u>	<u>\$ 108,212</u>
Supplemental disclosure of cash flow information:			
Cash paid during the period for:			
Interest .....	\$ 28,736	\$ 14,769	\$ 7,011
Income taxes .....	18,210	20,124	6,990

See accompanying notes to financial statements.

## PREFERRED BANK

### Notes to Financial Statements

#### (1) Summary of Significant Accounting Policies

Preferred Bank (the Bank) is a full service commercial bank and is engaged primarily in commercial, real estate, and international lending to customers with businesses domiciled in the state of California. The accounting and reporting policies of the Bank are in accordance with accounting principles generally accepted in the United States of America and conform to general practices in the banking industry. The following is a summary of the Bank's significant accounting policies.

##### *(a) Cash and Cash Equivalents*

Cash and cash equivalents include cash and due from banks, and federal funds sold, all of which have original maturities of less than 90 days.

##### *(b) Investment Securities*

The Bank classifies its debt and equity securities in two categories: held-to-maturity or available-for-sale. Securities that could be sold in response to changes in interest rates, increased loan demand, liquidity needs, capital requirements, or other similar factors are classified as securities available-for-sale. These securities are carried at fair value. Unrealized holding gains or losses, net of the related tax effect, on available-for-sale securities are excluded from income and are reported as a separate component of stockholders' equity as other comprehensive income net of applicable taxes until realized. Realized gains and losses from the sale of available-for-sale securities are determined on a specific-identification basis. Securities classified as held-to-maturity are those that the Bank has the positive intent and ability to hold until maturity. These securities are carried at amortized cost, adjusted for the amortization or accretion of premiums or discounts. At December 31, 2005 and 2004, there were no securities held for held-to-maturity purposes.

A decline in the fair value of any available-for-sale or held-to-maturity security below cost that is deemed to be other than temporary results in a reduction in carrying amount to fair value. The impairment is charged to income and a new cost basis for the security is established.

Premiums and discounts are amortized or accreted over the life of the related held-to-maturity or available-for-sale security as an adjustment to yield using the effective-interest method. Dividend and interest income are recognized when earned.

##### *(c) Loans and Loan Origination Fees and Costs*

Loans are carried at face value, less payments received, the allowance for loan and lease losses, and net deferred loan fees. Loans receivable are stated at the principal amount outstanding. Interest income is recorded on an accrual basis in accordance with the terms of the loans.

Loans on which the accrual of interest has been discontinued are designated as nonaccrual loans. The accrual of interest on loans is discontinued when principal or interest is past due 90 days or more unless the loan is both well secured and in the process of collection. When loans are placed on nonaccrual status, all interest previously accrued, but not collected, is reversed against current period interest income. Income on nonaccrual loans is subsequently recognized only to the extent that cash is received and the loan's principal balance is deemed collectible.

Loan origination fees, offset by certain direct loan origination costs and commitment fees, are deferred and recognized in income as a yield adjustment using the effective interest yield method over the contractual life of the loan, which approximates the interest method. If a commitment expires unexercised, the commitment fee is recognized as income.

## PREFERRED BANK

### Notes to Financial Statements—(Continued)

The Bank considers a loan to be impaired when it is “probable” that it will be unable to collect all amounts due (i.e., both principal and interest) according to the contractual terms of the loan agreement. The measurement of impairment may be based on (1) the present value of the expected future cash flows of the impaired loan discounted at the loan’s original effective interest rate, (2) the observable market price of the impaired loan, or (3) the fair value of the collateral of a collateral-dependent loan. The amount by which the recorded investment of the loan exceeds the measure of the impaired loan is recognized by recording a valuation allowance with a corresponding charge to the provision for loan losses. All classified loans that are over \$2 million are analyzed for impairment. The Bank recognizes interest income on impaired loans based on its existing methods of recognizing interest income on nonaccrual loans.

#### *(d) Allowance for Loan and Lease Losses*

Loan and lease losses are charged and recoveries are credited to the allowance account. Additions to the allowance account are charged to the provision for loan and lease losses. The allowance for loan and lease losses is maintained at a level considered adequate to provide for losses that are probable and reasonably estimatable. The adequacy of the allowance is determined by management based upon a periodic credit review of the loan and lease portfolio, consideration of historical loss experience, current economic conditions, changes in the composition of the portfolio, analysis of collateral values, and other pertinent factors.

Management believes that the allowance for loan and lease losses is adequate. While management uses available information to recognize losses on loans and leases, future adjustments to the allowance may be necessary based on changes in credit quality and economic conditions. In addition, various regulatory agencies, as an integral part of their examination process, periodically review the Bank’s allowance for loan and lease losses. Such agencies may require the Bank to recognize additions to the allowance based on their judgments about information available to them at the time of their examination.

#### *(e) Other Real Estate Owned (OREO)*

Other real estate owned, consisting of real estate acquired through foreclosure or other proceedings, is initially stated at fair value of the property based on appraisal, less estimated selling cost. Any cost in excess of the fair value at the time of acquisition is accounted for as a loan charge-off and deducted from the allowance for loan and lease losses. A valuation allowance is established for any subsequent declines in value through a charge to earnings. Operating expenses of such properties, net of related income, and gains and losses on their disposition are included in other operating income or expense, as appropriate.

#### *(f) Bank Furniture and Fixtures*

Bank furniture and fixtures are stated at cost, less accumulated depreciation and amortization. Depreciation on furniture and equipment is computed on a straight-line method over the estimated useful lives of the assets, generally three to five years. Leasehold improvements are capitalized and amortized on the straight-line method over the estimated useful life of the improvement or the term of lease, whichever is shorter.

#### *(g) Comprehensive Income*

Comprehensive income consists of net income and net unrealized gains (losses) on securities available-for-sale and is presented in the statements of income and comprehensive income.



## PREFERRED BANK

### Notes to Financial Statements—(Continued)

#### *(h) Income Taxes*

The Bank accounts for income taxes using the asset and liability method. The objective of the asset and liability method is to establish deferred tax assets and liabilities for the temporary differences between the financial reporting basis and the tax basis of the Bank's assets and liabilities at enacted tax rates expected to be in effect when such amounts are realized or settled. A valuation allowance is established for deferred tax assets 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. The valuation allowance is sufficient to reduce the deferred tax assets to the amount that is more likely than not to be realized.

#### *(i) Earnings per Share*

Earnings per share (EPS) are computed on a basic and diluted basis. Basic EPS excludes dilution and is computed by dividing income available to common stockholders by the weighted average number of common shares outstanding for the period. Diluted EPS reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock or resulted in the issuance of common stock that then shares in the earnings of the Bank.

#### *(j) Share-Based Compensation*

Employees and directors participate in the following stock option compensation plans—the 1992 Stock Option Plan, Interim Stock Option Plan and the 2004 Equity Incentive Plan which are discussed in Note 13.

Effective January 1, 2006, the Bank adopted Statement of Financial Accounting Standards No.123 (revised 2004), "Share-Based Payment" ("SFAS 123R"), using the modified prospective transition method and therefore has not restated results from prior periods. Under this transition method, share-based compensation expense for 2006 includes compensation expense for all share-based compensation awards granted prior to January 1, 2006, but not yet vested as of January 1, 2006, based on the grant-date fair value estimated in accordance with the original provisions of Statement of Financial Accounting Standards No.123, "Accounting for Stock-Based Compensation." Share-based compensation expense for all share-based payment awards granted or modified on or after January 1, 2006 is based on the grant-date fair value estimated in accordance with the provisions of SFAS No. 123R. The Bank recognizes these compensation costs on a straight-line basis over the requisite services period of the award, which is the option vesting term of the generally five years, for only those shares expected to vest. The fair value of stock option awards was estimated using the Black-Scholes option pricing model with the grant-date assumptions and weighted-average fair value.

Prior to the adoption of SFAS No. 123(R), the Bank accounted for stock compensation under the intrinsic value method permitted by Accounting Principles Board ("APB") Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB Opinion No. 25") and related interpretations. Accordingly, the Bank previously recognized no compensation cost for employee stock options that were granted with an exercise price equal to the market value of the underlying common stock on the date of grant.

For the year ended December 31, 2006, the Bank recognized share-based compensation expense of \$752,000 resulting in the recognition of \$33,000 in related tax benefits. Also, as a result of adopting SFAS 123 (R) on January 1, 2006, the Bank income before tax expense and net income for the year ended December 31, 2006 was \$752,000 and \$719,000 respectively lower than if the bank had continued to account for stock-based compensation under APB 25. Basic and diluted earnings per shares for the year ended December 31, 2006 were \$.07 and \$.07 lower, respectively, than if the Bank had continued to account for stock-based compensation under APB 25.

**PREFERRED BANK**

**Notes to Financial Statements—(Continued)**

SFAS No. 123(R) requires that cash flows resulting from the realization of tax deductions in excess of the compensation cost recognized (excess tax benefits) are to be classified as financing cash flows. Before the adoption of SFAS No. 123(R), the Bank presented all tax benefits realized from the exercise of stock options as operating cash flows in the Statements of Cash Flows.

Also SFAS 123 (R) require forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from initial estimates. Share-based compensation expense was recorded net of estimated forfeitures for the year ended December 31, 2006 such that expense was recorded only for those share-based awards that are expected to vest. Previously under APB 25, to the extent awards were forfeited prior to vesting, the corresponding previously recognized expense was reversed in the period of forfeiture.

For the Bank's stock option plans, compensation cost is based on the fair value of the underlying stock on the award date and is recognized over the requisite service period of the award. In 2005 and prior years, the Bank did not recognize compensation costs when granting stock options in the Bank's stock option plans. This was due to the exercise price of option grants being equal to or higher than the quoted market price of the Bank's common stock on the grant date as provided under the intrinsic value method of APB 25.

When options are exercised, the Bank's policy is to issue new shares of stock.

If the compensation cost for the Bank's stock option plan had been determined with the fair value at the grant dates for all awards under the Plan consistent with the method of SFAS No. 123 (R), *Share Based Payment*, prior to January 1, 2006, the Bank's net income and earnings per share amounts for the year ended December 31, 2005 and 2004 would have been reduced to the pro forma amounts indicated in the table below:

	2005	2004
	(Dollars in thousands)	
Net income, as reported . . . . .	\$ 16,825	\$ 11,152
Deduct total stock-based employee compensation expense determined under fair-value-based method for all awards, net of tax . . . . .	(426)	(72)
Pro forma net income . . . . .	\$ 16,399	\$ 11,080
	2005	2004
Earnings per share: <sup>(1)</sup>		
Basic—as reported . . . . .	\$ 1.72	\$ 1.35
Basic—pro forma . . . . .	1.68	1.34
Diluted—as reported . . . . .	1.65	1.28
Diluted—pro forma . . . . .	1.61	1.27
Weighted-average common shares		
Basic . . . . .	9,782,645	8,277,597
Diluted . . . . .	10,195,858	8,713,851

(1) Adjusted to reflect February 2007, 3 for 2 stock split, effected in the form of dividend

**(k) Statement of Cash Flows**

For purposes of reporting cash flows, cash and cash equivalents include cash on hand, amounts due from banks, and federal funds sold.

**PREFERRED BANK**

**Notes to Financial Statements—(Continued)**

**(l) Bank-Owned Life Insurance (BOLI)**

Bank-owned life insurance policies are carried at their cash surrender value. Income from BOLI is recognized when earned.

**(m) Use of Estimates**

Management of the Bank has made a number of estimates and assumptions relating to the reporting of assets and liabilities and the disclosure of contingent assets and liabilities to prepare these financial statements in conformity with accounting principles generally accepted in the United States of America. Actual results could differ from these estimates. The most significant estimate subject to change relates to the allowance for loan and lease losses.

**(n) Risk and Uncertainties**

The Bank's operations are located and concentrated primarily in Southern California and are likely to remain so for the foreseeable future. At December 31, 2006, approximately 96% of the total dollar amount of the Bank's loans and commitments was related to collateral or borrowers located within California. The performance of these loans may be affected by changes in California's economic and business conditions. Deterioration in economic conditions could have a material adverse effect on the quality of the Bank's loan portfolio and the demand for its products and services. In addition, during periods of economic slowdown or a recession, the Bank may experience a decline in collateral values and an increase in delinquencies and defaults. A decline in collateral values and an increase in delinquencies and defaults increase the possibilities and severity of losses. California real estate is also subject to certain natural disasters, such as earthquakes, fires, floods and mud slides, as well as civil unrest, which are typically not covered by the standard hazard insurance policies maintained by the borrowers. Uninsured disasters may render borrowers unable to repay loans made by the Bank and lower collateral values. The occurrence of adverse economic conditions or natural disasters in California could have a material adverse effect on the Bank's financial condition, results of operations, and business prospects.

**(o) Segment Reporting**

Through our branch network, we provide a broad range of financial services to individuals and companies located primarily in Southern California. Their services include demand, time and savings deposits and real estate, business and consumer lending. While our chief decision makers monitor the revenue streams of our various products and services, operations are managed and financial performance is evaluated on a company-wide basis. Accordingly, we consider all of our operations are aggregated in one reportable operating segment.

**(2) Securities Available for sale**

The amortized cost and estimated fair value of securities available-for-sale at December 31, 2006 and 2005 are summarized as follows:

	2006			
	Amortized cost	Gross unrealized gains	Gross unrealized losses	Estimated fair value
	(In thousands)			
U.S. Agency .....	\$142,270	\$ 28	\$(192)	\$142,106
Corporate notes .....	16,880	125	(348)	16,657
Mortgage-backed securities .....	17,376	8	(184)	17,200
Other securities .....	22,934	22	(230)	22,726
Total securities available-for-sale .....	\$199,460	\$183	\$(954)	\$198,689

**PREFERRED BANK**

**Notes to Financial Statements—(Continued)**

	2005			
	<u>Amortized cost</u>	<u>Gross unrealized gains</u>	<u>Gross unrealized losses</u>	<u>Estimated fair value</u>
	(In thousands)			
U.S. Agency .....	\$ 85,913	\$ 1	\$ (675)	\$ 85,239
Corporate notes .....	37,209	226	(972)	36,463
Mortgage-backed securities .....	16,234	11	(243)	16,002
Other securities .....	25,550	51	(370)	25,231
Total securities available-for-sale .....	<u>\$164,906</u>	<u>\$289</u>	<u>\$(2,260)</u>	<u>\$162,935</u>

Gross unrealized losses on securities available-for-sale and the fair value of the related securities, aggregated by investment category and length of time that the individual securities have been in a continuous unrealized loss position, at December 31, 2006 and 2005 are as follows:

	<u>Less than 12 months</u>		<u>12 months or greater</u>		<u>Total</u>	
	<u>Estimated fair value</u>	<u>Unrealized losses</u>	<u>Estimated fair value</u>	<u>Unrealized losses</u>	<u>Estimated fair value</u>	<u>Unrealized losses</u>
	(In thousands)					
U.S. Agency .....	\$ 96,823	\$ (73)	\$45,283	\$ (90)	\$142,106	\$ (163)
Corporate notes .....	8,311	(26)	8,346	(197)	16,657	(223)
Mortgage-backed securities .....	4,955	(43)	12,245	(134)	17,200	(177)
Other securities .....	9,467	(89)	13,259	(119)	22,726	(208)
	<u>\$119,556</u>	<u>\$(231)</u>	<u>\$79,133</u>	<u>\$ (540)</u>	<u>\$198,689</u>	<u>\$ (771)</u>

	2005					
	<u>Less than 12 months</u>		<u>12 months or greater</u>		<u>Total</u>	
	<u>Estimated fair value</u>	<u>Unrealized losses</u>	<u>Estimated fair value</u>	<u>Unrealized losses</u>	<u>Estimated fair value</u>	<u>Unrealized losses</u>
	(In thousands)					
U.S. Agency .....	\$ 61,725	\$(298)	\$23,514	\$ (377)	\$ 85,239	\$ (675)
Corporate notes .....	17,831	(212)	18,632	(760)	36,463	(972)
Mortgage-backed securities .....	—	—	16,002	(243)	16,002	(243)
Other securities .....	3,447	—	21,784	(370)	25,231	(370)
	<u>\$ 83,003</u>	<u>\$(510)</u>	<u>\$79,932</u>	<u>\$(1,750)</u>	<u>\$162,935</u>	<u>\$(2,260)</u>

The Bank's investment portfolio is primarily comprised of U.S. Agency securities, corporate notes, mortgage-backed securities, municipalities and Federal Home Loan Mortgage Corporation (FHLMC) preferred stock which are included in other securities. Approximately \$2,600,000 (or less than 1.3% of the total investment portfolio) is invested in FHLMC preferred stock at December 31, 2006. Other securities also include \$858,000 of time deposits with other financial institution.

At December 31, 2006, there were 48 and 44 investment securities that were in an unrealized loss position for less than 12 months and for 12 months or greater, respectively. Temporary impairments related to U.S. Agency securities, corporate notes, mortgage-backed securities, and municipal securities are primarily attributable to declining market prices caused by interest rate fluctuations. Unrealized losses on the FHLMC preferred stock are due mainly to lower interest rate environments, market conditions, and near term prospects of the issuer.

**PREFERRED BANK**

**Notes to Financial Statements—(Continued)**

Whenever the cost of an investment security exceeds its fair value, management evaluates, among other factors, general market conditions, the duration and extent to which cost is more than fair value, as well as specific adverse conditions affecting the business outlook of the issuer. During 2005 and 2004, the Bank's FHLMC preferred stock has been in an unrealized loss position. Although the Bank has the ability and intent to hold this investment until a market price recovery, management considered this investment to be other-than-temporarily impaired during 2004. Accordingly, the cost basis of the FHLMC preferred stock was written down by \$296,000 to reflect its approximate fair value in 2004. In 2006, management considered whether this investment is further other-than-temporarily impaired and believes that unrealized loss position is temporary in nature and no further other-than-temporarily impairment on this investment as of December 31, 2006 and 2005.

The amortized cost and estimated fair value of securities at December 31, 2006 and 2005, by contractual maturity, are shown below. Mortgage-backed securities are classified in accordance with their estimated average life. The average yield on mortgage-backed securities was 5.87% and 3.90% in 2006 and 2005, respectively. Expected maturities differ from contractual maturities mainly due to prepayment rates; changes in prepayment rates will affect a security's average life.

Cash proceeds from sales of securities available-for-sale totaled \$0, \$0 and \$5,094,000 in 2006, 2005, and 2004, respectively. Gross realized gains and losses on sales of securities available-for-sale totaled \$0, and \$0, respectively, in 2006, \$0 and \$0 respectively, in 2005, \$35,000 and \$2,000 respectively, in 2004 based on the specific-identification method. Investment securities having a fair value of approximately \$157.8 million and \$100.7 million were pledged to secure governmental deposits, treasury tax and loan deposits, borrowing line from the Federal Reserve Bank, and government deposits as of December 31, 2006 and 2005, respectively.

	2006	
	Amortized cost	Estimated fair value
	(In thousands)	
Due in one year or less . . . . .	\$118,413	\$118,271
Due after one year through five years . . . . .	26,499	26,568
Due after five years through ten years . . . . .	3,356	3,353
Due after ten years . . . . .	51,192	50,497
Total securities available-for-sale . . . . .	\$199,460	\$198,689
	2005	
	Amortized cost	Estimated fair value
	(In thousands)	
Due in one year or less . . . . .	\$ 83,511	\$ 83,003
Due after one year through five years . . . . .	19,703	19,455
Due after five years through ten years . . . . .	9,405	9,109
Due after ten years . . . . .	52,287	51,368
Total securities available-for-sale . . . . .	\$164,906	\$162,935

**PREFERRED BANK**

**Notes to Financial Statements—(Continued)**

**(3) Loans and Leases and Allowance for Loan and Lease Losses**

The loan and leases portfolio as of December 31, 2006 and 2005 is summarized as follows:

	<b>2006</b>	<b>2005</b>
	<b>(In thousands)</b>	
Real Estate .....	\$438,280	\$372,251
Commercial .....	201,385	149,428
Construction .....	271,021	171,646
Trade Finance .....	86,067	76,700
Installment/Consumer .....	45	266
Other Loans .....	185	320
Leases .....	334	532
	997,317	771,143
Less:		
Allowance for loan and lease losses .....	(10,236)	(8,939)
Deferred loan and fees, net .....	(1,759)	(1,537)
	<b>\$985,322</b>	<b>\$760,667</b>

The majority of the Bank's loans are to customers and businesses in the state of California and/or secured by properties located primarily in the greater Los Angeles metropolitan area. All loans are made based on the same credit standards regardless of where the customers and/or collateral properties are located.

The Bank had \$1.1 million of nonaccrual loans and leases at December 31, 2006 compared to \$0 at December 31, 2005. These loans and leases had interest due, but not recognized, of approximately \$41,000 and \$0 in 2006 and 2005, respectively.

The Bank had \$1.1 million and \$800,000 of impaired loans and leases as of December 31, 2006 and 2005, respectively. As of December 31, 2006 and 2005, the amount of impaired loans and leases for which there is a specific allowance for loan and lease loss was \$1.1 million and \$800,000, respectively, with the amount of the specific allowance for loan and lease loss of approximately \$11,000 and \$300,000, respectively. The average recorded investment in impaired loans and leases for 2006 and 2005 was \$1.2 million and \$186,000, respectively. Interest income recognized on such loans and leases during 2006 and 2005 was \$73,000 and \$41,000, respectively.

At December 31, 2006, the Bank had no commitments to lend additional funds to debtors whose loans are nonperforming.

Changes in the allowance for loan and lease losses are summarized as follows:

	<b>2006</b>	<b>2005</b>	<b>2004</b>
	<b>(In thousands)</b>		
Balance at beginning of year .....	\$ 8,939	\$6,724	\$ 6,168
Provision for credit losses .....	1,960	2,110	1,550
Loans and leases charged off .....	(663)	(5)	(1,103)
Recoveries .....	—	110	109
Balance at end of year .....	<b>\$10,236</b>	<b>\$8,939</b>	<b>\$ 6,724</b>

**PREFERRED BANK**

**Notes to Financial Statements—(Continued)**

**(4) Bank Furniture and Fixtures**

As of December 31, 2006 and 2005, furniture and fixtures consists of the following:

	<b>2006</b>	<b>2005</b>	<b>2004</b>
	(In thousands)		
Leasehold improvements . . . . .	\$ 1,104	\$ 3,300	\$ 2,376
Furniture, fixtures, and equipment . . . . .	3,242	3,260	3,144
	4,346	6,560	5,520
Less accumulated depreciation and amortization . . . . .	(2,635)	(4,725)	(4,155)
	<b>\$ 1,711</b>	<b>\$ 1,835</b>	<b>\$ 1,365</b>

Depreciation and amortization expense was \$568,000, \$579,000 and \$492,000 for the years ended December 31, 2006, 2005 and 2004, respectively.

**(5) Deposits**

Time deposit accounts at December 31, 2006 mature as follows:

<b>Year</b>	<b>Maturities of time deposits</b>
	(In thousands)
2007 . . . . .	\$704,417
2008 . . . . .	6,746
2009 . . . . .	1,094
	<b>\$712,257</b>

At December 31, 2006 and 2005, approximately \$157,806,000 and \$97,580,000, respectively, of the Bank's investment securities were pledged as collateral for certain public deposits. The amount of deposits from related parties was \$2,630,000, and \$7,172,000 at December 31, 2006 and 2005, respectively. The aggregate amount of overdrafts that have been reclassified as loan balances was \$24,000 and \$282,000 at December 31, 2006 and 2005, respectively.

**(6) Income Taxes**

The income taxes expense (benefit) for the years ended December 31, 2006, 2005 and 2004 was as follows:

	<b>2006</b>	<b>2005</b>	<b>2004</b>
	(In thousands)		
<b>Current:</b>			
Federal . . . . .	\$13,722	\$ 9,448	\$10,856
State . . . . .	4,235	3,268	3,066
	17,957	12,716	13,922
<b>Deferred:</b>			
Federal . . . . .	(1,178)	(1,055)	(5,426)
State . . . . .	(241)	(279)	(1,142)
	(1,419)	(1,334)	(6,568)
	<b>\$16,538</b>	<b>\$11,382</b>	<b>\$ 7,354</b>



**PREFERRED BANK**

**Notes to Financial Statements—(Continued)**

At December 31, 2006 and 2005, other assets include current income taxes receivable of \$1,908,000 and \$895,000 respectively. The income tax expense (benefit) for the year ended December 31, 2006 include an underpayment penalty in the amount of \$115,000 assessed by the Internal Revenue Service and the State of California Franchise Tax Board during the second quarter of 2006 for the 2004 tax year.

The components of the deferred tax assets and deferred tax liabilities as of December 31, 2006 and 2005 are as follows:

	<b>2006</b>	<b>2005</b>
	(In thousands)	
Deferred tax assets:		
Allowance for loan lease losses . . . . .	\$ 4,333	\$3,805
State taxes . . . . .	1,443	1,108
Other liabilities, mainly due to accrued bonuses . . . . .	1,329	1,155
Deferred compensation . . . . .	2,202	1,759
Bank furniture and fixtures, net . . . . .	397	294
Unrealized losses on securities available-for-sale . . . . .	324	829
Other . . . . .	85	—
Total deferred tax assets . . . . .	10,113	8,950
Deferred tax liabilities:		
Discount accretion . . . . .	(336)	(118)
FHLB stock . . . . .	(233)	(157)
Total deferred tax liabilities . . . . .	(569)	(275)
Net deferred tax assets . . . . .	\$ 9,544	\$8,675

In assessing the realizability of deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. Management considers the projected future taxable income and tax planning strategies in making this assessment. Based upon the level of historical taxable income and projections for future taxable income over the periods in which the deferred tax assets are deductible, management believes it is more likely than not the Bank will realize all benefits related to these deductible differences.

A reconciliation of the income tax provision and the amount computed by applying the statutory federal income tax rate to income before income taxes is as follows for the years ended December 31, 2006, 2005 and 2004 (in thousands):

	2006		2005		2004	
	Amount	Percentage	Amount	Percentage	Amount	Percentage
Statutory U.S. federal income tax . . . . .	\$13,961	35.0%	\$ 9,872	35.0%	\$6,477	35.0%
State taxes, net of federal benefit . . . . .	2,597	6.8	1,884	6.7	1,271	6.8
Life insurance policies . . . . .	(91)	(0.2)	(87)	(0.3)	(90)	(0.5)
Other . . . . .	71	(0.1)	(287)	(1.0)	(304)	(1.6)
	\$16,538	41.5%	\$11,382	40.4%	\$7,354	39.7%

**PREFERRED BANK**

**Notes to Financial Statements—(Continued)**

**(7) Federal Funds Purchased**

There were no federal funds purchased at December 31, 2006 and 2005 respectively. At December 31, 2006, the Bank had two federal funds borrowing lines in the amounts of \$30,000,000 and \$50,000,000 at two separate banks.

U.S. Treasury securities and U.S. Agency securities sold under repurchase agreements were delivered to the broker-dealers who arranged the transactions. The broker-dealers may have sold, loaned, or otherwise disposed of such securities to other parties in the normal course of their operation and have agreed to resell to the Bank identical securities at the maturities of the agreements. There were no outstanding amounts of these overnight agreements as of December 31, 2006, 2005 and 2004. There were no securities underlying these agreements at December 31, 2006, 2005 and 2004. These overnight agreements averaged approximately \$0, \$0 and \$41,000 during 2006, 2005 and 2004, respectively. The maximum amount outstanding at any month-end during 2006, 2005 and 2004 was \$0, \$0 and \$0, respectively. The average rate for the years ended December 31, 2006, 2005 and 2004 was 0%, 0% and 2.11%, respectively.

**(8) Other Borrowed Funds**

Advances from the Federal Home Loan Bank of San Francisco (FHLBSF) were \$20 million at December 31, 2006 and 2005. The average rate on the fixed rate debt were 3.71% and 3.72% at December 31, 2006 and 2005, respectively. All advances are collateralized by investment securities or residential real estate loans. At December 31, 2006, approximately \$182,639,500 of the Bank's real estate loans was pledged as collateral. At December 31, 2006, the outstanding advances mature as follows:

<u>Year</u>	<u>2006</u>
	(In thousands)
2009 .....	\$12,000
2011 .....	8,000
	<u>\$20,000</u>

The Bank had approved short-term borrowings line available through the discount window at the Federal Reserve Bank of San Francisco (FRBSF) in the amount of \$17.5 million. We had no borrowing outstanding through the discount window outstanding as of December 31, 2006.

**(9) Commitments and Contingencies**

The Bank is obligated under non-cancellable operating leases for the premises of its head office and regional offices. As of December 31, 2006, the future total minimum lease payments for the Bank's premises are as follows:

<u>Year</u>	<u>Total lease payment</u>
	(In thousands)
2007 .....	\$1,761
2008 .....	1,545
2009 .....	1,104
2010 .....	996
2011 .....	588
Thereafter .....	1,355
	<u>\$7,349</u>

## PREFERRED BANK

### Notes to Financial Statements—(Continued)

Rental expense was \$1,307,000, \$1,235,000, and \$1,036,000 for the years ended December 31, 2006, 2005 and 2004, respectively.

#### (10) Off-Balance-Sheet Risks

As a financial institution, the Bank enters into a variety of financial transactions with its customers in the normal course of business. Many of these products do not necessarily entail present or future funded asset or liability positions, instead the natures of these are considered in the form of executory contracts.

Financial instrument transactions are subject to the Bank's normal credit standards, financial controls and risk-limiting, and monitoring procedures. Collateral requirements are determined on a case-by-case evaluation of each customer and product.

The Bank's exposure to credit risk under commitments to extend credit, standby letters of credit, and financial guarantees written is limited to the contractual amount of those instruments.

At December 31, 2006 and 2005, the Bank had commitments to fund loans of \$512,376,000 and \$375,956,000, respectively. Other financial instruments with off-balance-sheet risk at December 31, 2006 and 2005 are as follows:

	<u>2006</u>	<u>2005</u>
	<u>(In thousands)</u>	
Commitments to extend credit .....	\$496,850	\$356,570
Commercial letters of credit .....	3,860	11,023
Standby letters of credit .....	<u>11,666</u>	<u>8,363</u>
Total .....	<u>\$512,376</u>	<u>\$375,956</u>

The Bank's exposure to credit losses in the event of non-performance by the other party to commitments to extend credit and standby letters of credit is represented by the contractual notional amount of those instruments. The Bank uses the same credit policies in making commitments and conditional obligations as it does for extending loan facilities to customers. The Bank evaluates each customer's credit-worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Bank upon extension of credit, is based on management's credit evaluation of the counterparty.

#### (11) Loans to Related Parties

The Bank has extended credit to certain directors and officers and companies in which they have an interest and certain stockholders which beneficially own more than 5% of the Bank's capital stock. In management's opinion, the loans to these related parties are made on substantially the same terms, including interest rates and collateral, as those made to nonrelated persons.

At December 31, 2006 and 2005, the aggregate loans (including commitments) to related parties were approximately \$12.3 million (of which \$734,000 was outstanding) and \$15.7 million (of which \$4.5 million was outstanding), respectively. All related party loans were current at December 31, 2006 and 2005.

**PREFERRED BANK**

**Notes to Financial Statements—(Continued)**

Changes in the outstanding loans are summarized as follows:

	<u>2006</u>	<u>2005</u>	<u>2004</u>
	(In thousands)		
Balance at beginning of year . . . . .	\$ 4,457	\$3,060	\$ 8,502
New loans . . . . .	—	750	—
Net drawdowns (repayments) . . . . .	(3,723)	647	(5,442)
Balance at end of year . . . . .	\$ 734	\$4,457	\$ 3,060

**(12) Restrictions on Cash Dividends, Regulatory Capital Requirements**

The Bank has authorized 5,000,000 shares of preferred stock. The Board has the authority to issue the preferred stock in one or more series, and to fix the designations, rights, preferences, privileges, qualifications, and restrictions, including dividend rights, conversion rights, voting rights and terms of redemptions, liquidation preferences, and sinking fund terms, any or all of which may be greater than the rights of the common stock.

Under Section 642 of the California Financial Code, funds available for cash dividend payments by a bank are restricted to the lesser of: (i) retained earnings or (ii) the bank’s net income for its last three fiscal years (less any distributions to stockholders made during such period). Cash dividends may also be paid out of the greatest of: (i) retained earnings, (ii) net income for a bank’s last preceding fiscal year, or (iii) net income of the Bank for its current fiscal year upon the prior approval of the Commissioner of Financial Institutions, State of California, without regard to retained earnings or net income for its prior three fiscal years.

The Bank is subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory—and possibly additional discretionary—actions by regulators that, if undertaken, could have a direct effect on the Bank’s financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of the Bank’s assets, liabilities, and certain off-balance-sheet items, as calculated under regulatory accounting policies. The Bank’s capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

The quantitative measures established by the regulation to ensure capital adequacy require the Bank to maintain amounts and ratios (set forth in the table below) of total and Tier 1 risk-based capital (as defined in the regulation) to risk-weighted assets (as defined) and of Tier 1 risk-based capital (as defined) to average assets (as defined). Management believes, as of December 31, 2006, that the Bank meets all capital adequacy requirements to which it is subject.

As of December 31, 2005, the most recent notification from the FDIC categorized the Bank as “well capitalized” under the regulatory framework for prompt corrective action. There are no conditions or events since that notification that management believes changed the institution’s category.

**PREFERRED BANK**

**Notes to Financial Statements—(Continued)**

The Bank’s actual and required capital amounts and ratios are presented in the following table:

	<u>Actual</u>		<u>For capital adequacy purposes</u>		<u>To be well capitalized under prompt corrective action provision</u>	
	<u>Amount</u>	<u>Rate</u>	<u>Amount</u>	<u>Rate</u>	<u>Amount</u>	<u>Rate</u>
	(In thousands)					
As of December 31, 2006:						
Total risk-based capital . . . . .	\$156,656	12.33%	\$101,634	≥8.00%	\$127,042	≥10.00%
Tier I risk-based capital . . . . .	146,350	11.52%	50,817	4.00	76,225	6.00
Leverage ratio . . . . .	146,350	11.50%	50,817	4.00	63,521	5.00
As of December 31, 2005:						
Total risk-based capital . . . . .	\$133,842	13.51%	\$ 79,282	≥8.00%	\$ 99,102	≥10.00%
Tier I risk-based capital . . . . .	124,793	12.59%	39,641	4.00	59,461	6.00
Leverage ratio . . . . .	124,793	11.63%	39,641	4.00	49,551	5.00

**(13) Share-Based Compensation**

The Bank remunerates employees and directors through stock option compensation plans; the 1992 Stock Option Plan, Interim Stock Option Plan and the 2004 Equity Incentive Plan which are discussed below. Effective January 1, 2006, the Bank adopted Statement of Financial Accounting Standards No.123 (revised 2004), “Share-Based Payment” (“SFAS 123R”), using the modified prospective transition method and therefore has not restated results from prior periods. Under this transition method share-based compensation expense for 2006 includes compensation expense for all share-based compensation awards granted prior to January 1, 2006, but not yet vested as of January 1, 2006, based on the grant-date fair value estimated in accordance with the original provisions of Statement of Financial Accounting Standards No.123, “Accounting for Stock-Based Compensation.” Share-based compensation expense for all share-based payment awards granted or modified on or after January 1, 2006 is based on the grant-date fair value estimated in accordance with the provisions of SFAS No. 123R. The Bank recognizes these compensation costs on a straight-line basis over the requisite services period of the award, which is the option vesting term of the generally five years, for only those shares expected to vest. The fair value of stock option awards was estimated using the Black-Scholes option pricing model with the grant-date assumptions and weighted-average fair value.

The number of stock options and per stock option data has been adjusted to reflect the Bank’s February 20, 2007 three-for-two stock split effected in the form of a dividend.

**1992 Stock Option Plan and Interim Stock Option Plan**

The Bank’s 1992 Stock Option Plan (the “1992 Plan”) provides for granting of nonstatutory stock options and incentive stock options to key full-time employees, officers, and the directors of the Bank. The number of shares authorized in this plan is 1,447,920 shares. The 1992 Stock Option Plan expired by its terms in 2003, and no shares are available for future grants. The options vest in installments of 20% each year and become fully vested after five years. Options under the 1992 Plan expire ten years after the grant date.

Because the 1992 Plan expired in 2003, the Bank did not issue any options under this Plan during 2006 and 2005.

In May 2003, April 2004 and June 2004, we granted an additional 81,000, 48,000 and 150,000 stock options, respectively, to our employees and directors at exercise prices ranging from \$10.69 to \$19.04 per share

**PREFERRED BANK**

**Notes to Financial Statements—(Continued)**

under the Bank’s Interim Stock Option Plan (“Interim Plan”). Even though the terms of these stock options are consistent with the terms of the stock options granted under our 1992 Plan, these stock options are outside of the 1992 Plan because they were granted after the 1992 Plan’s expiration.

The total intrinsic value of share options exercised during the year ended December 31, 2006 and 2005 was \$5,834,000 and \$4,490,000 respectively from the 1992 Plan and the Interim Plan. As of December 31, 2006, the total compensation cost not yet recognized that relates to unvested options granted under the 1992 Plan and Interim Plan was \$139,000 with a weighted-average recognition period of 1.7 years.

For the years ended December 31, 2004, the estimated weighted-average fair value per share of options granted under the 1992 Plan and the Interim Plan were as follows:

December 31, 2004  
\$1.47

The estimated weighted-average fair value per share of options granted was estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted-average assumptions:

	<b>December 31, 2004</b>
Weighted Average Assumptions: .....	
Dividend Yield .....	2.00%
Expected Volatility .....	0.00%
Expected Term .....	5.0Yrs
Risk-Free Interest Rate .....	3.82%

Expected volatility used in the calculation for 2004 was 0% due to the lack of trading volume in Preferred Bank stock. The expected term of the options represents the period of time that options granted are expected to be outstanding based primarily on the historical exercise behavior associated with previous option grants. The risk-free interest rate is based on the 5 year U.S. Treasury CMT at the time of grant for a period equal to the expected term of the options granted.

The following information under the 1992 Plan and the Interim Plan is presented for the years ended December 31, 2006, 2005 and 2004.

	<b>December 31,</b>		
	<b>2006</b>	<b>2005</b>	<b>2004</b>
Grant Date Fair Value of Options Granted .....	—	—	291
Fair Value of Options Vested .....	162	106	39
Total Intrinsic Value of Options Exercised .....	5,834	4,490	2,847
Cash Received From Options Exercised .....	1,924	1,510	923
Actual Tax Benefit Realized from Options Exercised .....	506	6	206

**PREFERRED BANK**

**Notes to Financial Statements—(Continued)**

The following is a summary of the transactions under the 1992 Plan and the Interim Plan for the years ended December 31, 2006:

	1992 Plan and Interim Plan	
	Number of Option	Weighted Average Exercise Price
Options Outstanding at December 31, 2003 .....	871,950	\$ 8.12
Granted .....	198,000	19.01
Exercised .....	(148,800)	6.20
Forfeited .....	(17,250)	11.94
Options Outstanding at December 31, 2004 .....	903,900	10.75
Granted .....	—	27.91
Exercised .....	(228,150)	6.64
Forfeited .....	(7,350)	17.57
Options Outstanding at December 31, 2005 .....	668,400	12.07
Granted .....	—	—
Exercised .....	(225,450)	8.53
Forfeited .....	(2,400)	12.25
Options Outstanding at December 31, 2006 .....	440,550	\$13.89

As of December 31, 2006, stock options outstanding under the 1992 Plan and the Interim Plan were as follows:

Exercise Price Range	Options Outstanding			Options Exercisable		
	Number of Outstanding Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life	Number of Exercisable Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life
\$5.00-\$9.99 .....	93,000	\$ 7.57	1.81	93,000	\$ 7.57	1.81
\$10.00-\$14.99 .....	136,800	\$10.69	6.30	77,700	\$10.69	6.29
\$15.00-\$19.99 .....	210,750	\$18.74	7.17	89,850	\$18.54	5.80

**2004 Equity Incentive Plan**

The Bank's 2004 Equity Incentive Plan (the "2004 Plan") provides for granting of nonstatutory stock options and incentive stock options to key full-time employees, officers, and the directors of the Bank. Stock options granted under the Plan have an exercise price equal to the fair market value of the underlying common stock on the date of grant. Stock options granted under the 2004 Plan generally vest in installments of 20% each year and become fully vested after five years and expire ten years from the date of grant. Certain option and share awards provide for accelerated vesting if there is a change in control (as defined in the Plan). The number of shares authorized in this plan is 1,800,000 shares.

The total intrinsic value of share options exercised during the year ended December 31, 2006 and 2005 was \$124,000 and \$0, respectively. As of December 31, 2006, the total compensation cost not yet recognized that relates to unvested options granted under the 2004 Plan was \$2,182,000 with a weighted-average recognition period of 3.1 years.



**PREFERRED BANK**

**Notes to Financial Statements—(Continued)**

For the years ended December 31, 2006, 2005 and 2004, the estimated weighted-average fair value per share of options granted under the 2004 Plan were as follows:

December 31,		
2006	2005	2004
\$7.87	\$8.05	\$6.80

The estimated weighted-average fair value per share of options granted was estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted-average assumptions:

	December 31,		
	2006	2005	2004
Weighted Average Assumptions:			
Dividend Yield	1.89%	2.00%	2.00%
Expected Volatility	26.58%	27.00%	27.00%
Expected Term	4.25Yrs	6.5Yrs	6.50Yrs
Risk-Free Interest Rate	4.70%	4.46%	3.52%

Expected volatility is determined based on the historical daily volatility of a peer group of similar banks due to the short period that the bank's stock has been publicly traded over a period equal to the expected term of the options granted. The expected term of the options represents the period of time that options granted are expected to be outstanding based primarily on the historical exercise behavior associated with previous option grants. The risk-free interest rate is based on the 5 year U.S. Treasury CMT at the time of grant for a period equal to the expected term of the options granted.

The following information under the 2004 Plan is presented for the years ended December 31, 2006, 2005 and 2004:

	December 31,		
	2006	2005	2004
Grant Date Fair Value of Options Granted	561	3,942	—
Fair Value of Options Vested	1,193	637	—
Total Intrinsic Value of Options Exercised	124	—	—
Cash Received From Options Exercised	291	—	—
Actual Tax Benefit Realized from Options Exercised	4	—	—

**PREFERRED BANK**

**Notes to Financial Statements—(Continued)**

The following is a summary of the transactions under the 2004 Plan for the years ended December 31, 2006, 2005 and 2004.

	2004 Plan	
	Number of Options	Weighted Average Exercise Price
Options Outstanding at December 31, 2003 .....	—	\$ —
Granted .....	—	—
Exercised .....	—	—
Forfeited .....	—	—
Options Outstanding at December 31, 2004 .....	—	—
Granted .....	489,750	25.39
Exercised .....	—	—
Forfeited .....	(10,500)	25.33
Options Outstanding at December 31, 2005 .....	479,250	25.39
Granted .....	71,250	34.44
Exercised .....	(11,400)	25.54
Forfeited .....	(15,150)	27.13
Options Outstanding at December 31, 2006 .....	523,950	\$26.37

As of December 31, 2006, stock options outstanding under the 2004 Plan were as follows:

Exercise Price Range	Options Outstanding			Options Exercisable		
	Number of Outstanding Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life	Number of Exercisable Options	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life
\$25.00 – \$ 29.99 .....	452,700	\$25.37	7.90	175,200	\$25.35	7.89
\$30.00 – \$ 34.99 .....	56,250	\$31.92	9.15	—	\$31.92	—
\$35.00 – \$ 39.99 .....	15,000	\$35.91	9.55	—	\$35.91	—

**(14) Employee Benefit Plan**

Effective January 1, 1994, the Bank began a 401k profit sharing plan for its eligible employees. Under the plan, the Bank matches 50% of a participant's contributions up to 6% of his/her salary subject to federal limitations on maximum contributions. Contributions made by the Bank for the years ended December 31, 2006, 2005 and 2004 totaled \$138,000, \$129,000 and \$106,000 respectively.

**(15) Bonus Plan**

In April 1994, the Management Incentive Bonus Plan was approved. The plan is administered by the Compensation Committee of the Board of Directors (the Committee). The Committee determines which employees may participate in the plan, the total amount of bonus payable to our employees each year, the amount of bonus to be carried over and paid in subsequent years and the allocation of the total amounts among our chairman, officers, and other employees. All awards are contingent upon the Bank attaining certain financial objectives. Total expense of the plan recorded by the Bank was approximately \$6,610,000, \$5,335,000 and \$4,626,000 for 2006, 2005 and 2004, respectively. As of December 31, 2006 and 2005, the total bonus accrual

## **PREFERRED BANK**

### **Notes to Financial Statements—(Continued)**

included in the other liabilities amounted to \$9,262,000 and \$7,293,000 respectively. The amounts accrued are paid out within a three-year period subsequent to the year the bonus was granted. There is no vesting requirement to receive the bonus; however, employees must be employed with the Bank at the time the bonus is distributed.

#### **(16) Deferred Compensation Arrangements**

In 1996, the Bank implemented deferred compensation arrangements for the Bank's senior officers and directors. Pursuant to the Plan, each participant receives benefits for his/her deferred compensation upon his/her retirement or termination of service with the Bank prior to retirement. At December 31, 2006 and 2005, liabilities recorded for deferred compensation plan totaled approximately \$5,240,000 and \$4,185,000, respectively.

In order to economically fund its obligation under the deferred compensation arrangements, the Bank purchased a single-premium life insurance policy under which the executive officers and directors are the insured, while the Bank is the owner and beneficiary thereof. At December 31, 2006 and 2005, the cash surrender value of the policies totaled \$7,759,000 and \$7,637,000, respectively. During 2006 and 2005, the income on the insurance policies was \$334,000 and \$312,000, respectively.

#### **(17) Litigation**

From time to time, the Bank is a party to claims and legal proceedings arising in the ordinary course of business. There are no pending legal proceedings or, to the best of management's knowledge, threatened legal proceedings, to which the Bank is a party which may have a material adverse effect upon the Bank's financial condition, results of operations, or business prospects.

#### **(18) Stockholders' Equity**

On January 25, 2007 Preferred Bank announced that its Board of Directors had declared a 3-for-2 stock split to be paid in the form of dividend. Each stockholder of record at the close of business on February 5, 2007 received one additional share of common stock for every two shares of common stock that they owned as of such date. The additional shares were distributed on February 20, 2007. A stockholder who would otherwise be entitled to receive a fractional share of common stock will receive in lieu thereof, cash in a proportional amount based on the closing price of the common stock on the Nasdaq Stock Exchange on the record date. After giving effect to the stock split, we have retroactively adjusted the number of common shares outstanding at December 31, 2006 and 2005 to 10,274,632 and 10,037,782, respectively. Accordingly, all references in the accompanying statements of financial condition, income and comprehensive income, statement of changes in shareholders' equity, and footnotes to the number of common shares and earnings per share amounts have been retroactively adjusted for all period presented.

**PREFERRED BANK**

**Notes to Financial Statements—(Continued)**

**(19) Earnings per Share**

The following table summarizes the basic and diluted earnings per share calculations for the periods indicated:

	<u>2006</u>	<u>2005</u>	<u>2004</u>
	(In thousands, except per share data)		
Net Earnings .....	\$ 23,351	\$ 16,825	\$ 11,152
Weighted Avg Basic Shares <sup>(1)</sup> .....	10,194,515	9,782,645	8,277,597
Effect of Dilutive Securities:			
Dilutive Stock Options .....	<u>361,767</u>	<u>413,313</u>	<u>436,254</u>
Weighted Average Diluted Shares <sup>(1)</sup> .....	<u>10,556,282</u>	<u>10,195,958</u>	<u>8,713,851</u>
Earnings per share: <sup>(1)</sup>			
Basic .....	\$ 2.29	\$ 1.72	\$ 1.35
Diluted .....	\$ 2.21	\$ 1.65	\$ 1.28

(1) Adjusted to reflect February 2007, 3 for 2 stock split, effected in the form of dividend

**(20) Quarterly Financial Data (Unaudited)**

The following tables summarize the quarterly unaudited financial data for 2006 and 2005:

**Quarterly Financial Data (Unaudited)**

<u>Year Ended December 31, 2006</u>	<u>Three months ended</u>			
	<u>Mach 31</u>	<u>June 30</u>	<u>September 30</u>	<u>December 31</u>
	(in thousands, except per share data)			
Interest Income .....	\$19,274	\$21,417	\$23,654	\$25,877
Interest Expense .....	<u>6,037</u>	<u>7,152</u>	<u>8,432</u>	<u>9,803</u>
Interest Income before provision for credit losses .....	13,237	14,265	15,222	16,074
Provision for credit losses .....	560	350	350	700
Noninterest income .....	798	809	724	736
Noninterest expense .....	4,825	5,017	5,127	5,045
Income taxes .....	<u>3,530</u>	<u>4,187</u>	<u>4,390</u>	<u>4,431</u>
Net Income .....	<u>\$ 5,119</u>	<u>\$ 5,520</u>	<u>\$ 6,078</u>	<u>\$ 6,634</u>
Earnings per share <sup>(1)</sup>				
Basic .....	\$ 0.51	\$ 0.54	\$ 0.59	\$ 0.65
Diluted .....	\$ 0.49	\$ 0.52	\$ 0.57	\$ 0.62

(1) Adjusted to reflect February 2007, 3 for 2 stock split, effected in the form of dividend.

**PREFERRED BANK**

**Notes to Financial Statements—(Continued)**

<u>Year Ended December 31, 2005</u>	<u>Three months ended</u>			
	<u>Mach 31</u>	<u>June 30</u>	<u>September 30</u>	<u>December 31</u>
	(in thousands, except per share data)			
Interest Income .....	\$12,487	\$14,007	\$15,863	\$17,807
Interest Expense .....	2,810	3,512	4,500	5,241
Interest Income before provision for credit losses .....	9,677	10,495	11,363	12,566
Provision for credit losses .....	510	570	580	450
Noninterest income .....	961	1,034	956	918
Noninterest expense .....	4,264	4,250	4,397	4,742
Income taxes .....	2,333	2,717	2,974	3,358
Net Income .....	<u>\$ 3,531</u>	<u>\$ 3,992</u>	<u>\$ 4,368</u>	<u>\$ 4,934</u>
Earnings per share <sup>(1)</sup>				
Basic .....	\$ 0.39	\$ 0.40	\$ 0.44	\$ 0.49
Diluted .....	\$ 0.37	\$ 0.39	\$ 0.42	\$ 0.47

(1) Adjusted to reflect February 2007, 3 for 2 stock split, effected in the form of dividend.

**(21) Fair Value of Financial Instruments**

SFAS No. 107, *Disclosures about Fair Value of Financial Instruments* (SFAS No. 107), requires that an entity disclose the fair value of all financial instruments, as defined, regardless of whether recognized in the financial statements of the reporting entity. For purposes of determining fair value, SFAS No. 107 provides that the fair value of a financial instrument is the amount at which the instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale.

The following methods and assumptions were used to estimate the fair value of each class of financial instruments.

**(a) Cash Due from Banks, Federal Funds Sold and Securities Purchased under Resale Agreements**

For cash and short-term instruments whose original or purchased maturity is less than 90 days, the carrying amount was assumed to be a reasonable estimate of fair value.

**(b) Securities available-for-sale**

For securities available-for-sale, fair values were based on quoted market prices obtained from market quotes. If a quoted market price was not available, fair value was estimated using quoted market prices for similar securities.

**(c) Loans**

Fair values were estimated for portfolios of loans with similar financial characteristics. Each loan category was further segmented into fixed and adjustable rate interest terms and by performing and nonperforming categories.

The fair value of performing loans was calculated by discounting scheduled cash flows through the estimated maturity using estimated market discount rates that reflect the credit and interest rate risk inherent in the loan.

**PREFERRED BANK**

**Notes to Financial Statements—(Continued)**

Fair value for nonperforming real estate loans was based on recent external appraisals of the underlying collateral of the loan. If appraisals were not available, estimated cash flows were discounted using a rate commensurate with the risk associated with the estimated cash flows. Assumptions regarding credit risk, cash flows, and discount rates were judgmentally determined using available market information and specific borrower information.

**(d) *Accrued Interest Receivable and Accrued Interest Payable***

The carrying amount of accrued interest receivable and accrued interest payable approximate its fair value due to their short-term nature.

**(e) *Deposits***

The fair value of demand deposits, saving accounts, and certain money market deposits was assumed to be the amount payable on demand at the reporting date. The fair value of fixed maturity certificates of deposit was estimated using the rates currently offered for deposits with similar remaining maturities.

**(f) *FHLB Borrowings***

The fair value of FHLB borrowings was based on rates currently offered for borrowings with similar remaining maturities.

**(g) *Commitment to Extend Credit and Letters of Credit***

The majority of our commitments to extend credit carry market interest rates if converted to loans. Because these commitments are generally unassignable by either the borrower or us, they only have value to the borrower and us. The estimated fair value is not material. The fair value of letters of credit was based on fees currently charged for similar agreements or on the estimated cost to terminate them or otherwise settle the obligations with the counterparties at the reporting date.

	December 31, 2006		December 31, 2005	
	Carrying amount	Estimated fair value	Carrying amount	Estimated fair value
	(In thousands)			
<b>Assets:</b>				
Cash and cash equivalents . . . . .	\$130,578	130,578	\$183,423	\$183,423
Securities available-for-sale . . . . .	198,689	198,689	162,935	162,935
Loans, net of allowance and net deferred loan fees . . . . .	985,322	984,842	760,667	759,554
Accrued interest receivable . . . . .	8,633	8,633	5,684	5,684
<b>Liabilities:</b>				
Demand deposits and savings:				
Non-interest bearing . . . . .	\$224,982	224,982	\$211,942	\$211,942
Interest-bearing . . . . .	224,105	224,105	154,552	154,552
Time deposits . . . . .	712,257	719,878	560,539	561,625
FHLB borrowings . . . . .	20,000	20,000	20,000	19,417
Commitments to extend credit and letters of credit . . . . .	—	233	—	106
Accrued interest payable . . . . .	5,272	5,272	2,584	2,584

The fair value estimates do not reflect any premium or discount that could result from offering the instruments for sale. Potential taxes and other expenses that would be incurred in an actual sale or settlement are not reflected in amounts disclosed. The fair value estimates are dependent upon subjective estimates of market conditions and perceived risks of financial instruments at a point in time and involve significant uncertainties resulting in variability in estimates with changes in assumptions.

**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Dated: March 29, 2007

PREFERRED BANK  
(Registrant)

By \_\_\_\_\_ /s/ LI YU  
**Li Yu**  
**Chairman of the Board, President**  
**and Chief Executive Officer**

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant in the capacities and on the dates indicated.

/s/ LI YU <b>Li Yu</b>	Chairman of the Board, President, Chairman and Chief Executive Officer (principal executive officer)	March 29, 2007
/s/ EDWARD J. CZAJKA <b>Edward J. Czajka</b>	Senior Vice President and Chief Financial Officer (principal financial and accounting officer)	March 29, 2007
/s/ J. RICHARD BELLISTON <b>J. Richard Belliston</b>	Director	March 29, 2007
/s/ WILLIAM C.Y. CHENG <b>William C.Y. Cheng</b>	Director	March 29, 2007
/s/ CLARK HSU <b>Clark Hsu</b>	Director	March 29, 2007
/s/ FRANK T. LIN <b>Frank T. Lin</b>	Director	March 29, 2007
/s/ GARY S. NUNNELLY <b>Gary S. Nunnelly</b>	Director	March 29, 2007
<b>Chih-Wei Wu</b>	Director	March 29, 2007
/s/ ALBERT YU <b>Albert Yu, Ph.D.</b>	Director	March 29, 2007
<b>Ambassador Jason G. Yuan</b>	Director	March 29, 2007