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THE FINANCIAL CRISIS OF THE 21ST CENTURY

The Financial Crisis of the 21st Century began on or about August 1, 2007. That is when the first mortgage backed securities began to default. However, the crisis became apparent to most about a year later in the summer of 2008 when these mortgage backed securities became widespread.

THE CAUSE OF THE FINANCIAL CRISIS

The cause of the financial crisis can be attributed to many sources. I have listed a number of the parties to the crisis below:

1. The home buyer or borrower who purchased a home and agreed to a loan they could not afford.
2. The real estate broker who sold the home the home buyer could not afford.
3. The mortgage broker who negotiated the mortgage the home buyer could not afford.
4. The mortgage company that underwrote the loan.
5. The appraiser who inflated the appraisal.
6. The GSEs that guaranteed the loans.
7. The investment banks that securitized the loans.
8. The rating agencies that rated the securitized mortgage pools AAA when they should have been rated "junk."

So, there is enough blame to go around. I believe it is particularly significant that FNMA and FHLMC reduced or lowered their credit standards in the late 1990s. This allowed borrowers to qualify for loans they could not afford. It also encouraged the very aggressive credit practices of mortgage lenders that led to the "sub-prime" mortgages that included "low-doc," "no-doc, and "stated income" loans.

I recall making a speech to a group of 75 women in November of 2004. After my remarks, one of them asked me what I thought about "sub-prime" loans. I responded by saying that "sub-prime" meant that the loan did not qualify under normal lending criteria. I went on to say that it was a recipe for disaster, and the longer it went on, the bigger the disaster was going to be. I had no idea it would be as pervasive and severe as it has been. I did not realize that these mortgage backed securities would be distributed in such large amounts around the world.

CHANGES IN THE REAL ESTATE MARKET

The real estate market exploded following the 2001 recession. It was evolutionary, but it accelerated at a pace never seen in the history of the world. This was supported by the increased availability of credit through the more and more aggressive financing that I referred to above. This was facilitated by the investment banks securitizing the loans and selling them to investors. It led to unqualified homeowners buying homes they could not afford and to a huge increase in homes purchased by investors. In one year, 46% of the homes purchased in the Inland Empire of California were purchased by investors.

THE IMPACT ON OUR BANK

Bank performance is heavily dependent on economic performance. When the economy is good, bank performance is generally good. When it is bad, bank performance is usually bad. The crisis originated with the collapse of the residential mortgage backed securities market, but the ripple

effect have extended to every corner of the economy. This has led to a collapse of all real estate markets, particularly the commercial real estate market.

The commercial real estate market and commercial real estate loans have been the primary business of community bank America. So, the decline in this industry and the related properties has had an adverse affect on virtually all community banks. Ours included, although not nearly to the extent of many others. We have continued to perform relatively well so far.

We did participate in the Capital Purchase Program under the Temporary Asset Relief Program. Our bank sold $132 million in preferred securities under that program in November of 2008. We did it as an insurance policy to protect us from the unknown consequences of the financial crisis. We did not know how serious the economic decline would be, and the capital markets were frozen at the time. The terms of the Capital Purchase Program were changed significantly four months after we issued the securities, so we proceeded to redeem the securities and repurchase the warrants. We completed a secondary common stock sale in July of 2009 to redeem the securities and relieve our company of the related requirements. This was achieved in September of 2009.

IMPACT ON CREDIT

The demand for credit, the credit quality of prospective borrowers and credit availability have all shrunk significantly. Demand for credit is weak, because qualified borrowers are being very conservative. Small business is preoccupied with the uncertainties of the economic recovery, health care costs and taxes. So, they are not hiring or expanding, except in unusual cases. Many prospective borrowers no longer qualify as a result of the adverse economic impact on their business. Virtually all businesses have seen a decline in their revenues and earnings.

Credit availability always compresses in recessionary periods. Banks experience financial difficulty as a result of the credit deterioration during recessions. Many are placed under regulatory supervision. The regulators mandate that the troubled banks increase their capital

ratios and liquidity. A typical response is to curtail lending to reduce assets and increase the capital to asset ratio. The loan reductions can also improve liquidity. In many cases, the regulatory authorities will mandate a reduction in loans, or certain types of loans where there are concentrations.

We are making loans. In fact, we are eager to make loans. However, there is a lack of loan demand, as I mentioned above. Nevertheless, we are making new loans every day. Just not as many as we would like.

REGULATION

Regulatory oversight has increased significantly. It always does during recessions. This is my third recession in a senior type of capacity (two as President and this one as Vice Chairman). This additional oversight is appropriate when bank financial conditions deteriorate. The regulators have to honor their responsibility to prompt changes under these circustances. They are also often blamed for some of the deterioration, and under pressure from the Administration and Congress to correct these conditions.

We have always enjoyed a positive relationship with our regulators and their examiners. They are generally constructive and helpful. Sometimes there are differences, but we always resolve them in a positive manner.

Bank regulation has not changed a great deal since 2008, except for the moritoriums on mortgages and defaults. I believe these measures have been counterproductive. They have only delayed the inevitable in the majority of cases. This seems to be borne out by the large number of redefaults.

I have deep concerns about the Dodd-Frank legislation. It seems to be targeted toward banks,

who are already the most heavily regulated industry in the private sector. It does not address the weaknesses in regulation and oversight of the real estate industry, mortgage industry, appraisal business and the rating agencies.

The legislation consists of 2,300 pages, calls for 559 new rules, 81 studies and 93 congressional reports. And now, it is being delegated to ten regulatory agencies to draft the regulations to implement the legislation. It is estimated that it will result in 5,000 additional pages of bank regulation. This is in addition to the 9,000 that already exist. And I will assure you that if the estimate is 5,000. it will be closer to 10,000.

I trust that this will be responsive to your request.