PROVIDENT FINANCIAL HOLDINGS INC
Form 10-Q
February 09, 2009

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended …………………………………................................................. December

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

For the transition period from ________________ to _________________

Commission File Number 000-28304

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

| | |
|---|---|
| Delaware | 33-0704889 |
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |

3756 Central Avenue, Riverside, California 92506
(Address of principal executive offices and zip code)

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

.

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes X . No .

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

Large accelerated filer [ ] Accelerated filer [X] Non-accelerated filer [ ]
Smaller reporting company [ ]

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

Yes . No X .

APPLICABLE ONLY TO CORPORATE ISSUERS

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

| | |
|---|---|
| Title of class: | As of February 5, 2009 |
| Common stock, $ 0.01 par value, per share | 6,208,519 shares |

PROVIDENT FINANCIAL HOLDINGS, INC.

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PROVIDENT FINANCIAL HOLDINGS, INC.
Condensed Consolidated Statements of Financial Condition
(Unaudited)
Dollars in Thousands

| | December 31, 2008 | June 30, 2008 |
|---|---|---|
| Assets | | |
| Cash and due from banks | $ 17,514 | $ 12,614 |
| Federal funds sold | - | 2,500 |
| Cash and cash equivalents | 17,514 | 15,114 |
| | | |
| Investment securities – available for sale, at fair value | 144,931 | 153,102 |
| Loans held for investment, net of allowance for loan losses of $34,953 and $19,898, respectively | 1,265,404 | 1,368,137 |
| Loans held for sale, at lower of cost or market | 46,447 | 28,461 |
| Accrued interest receivable | 6,712 | 7,273 |
| Real estate owned, net | 11,115 | 9,355 |
| Federal Home Loan Bank ("FHLB") – San Francisco stock | 32,929 | 32,125 |
| Premises and equipment, net | 6,687 | 6,513 |
| Prepaid expenses and other assets | 19,409 | 12,367 |
| | | |
| Total assets | $ 1,551,148 | $ 1,632,447 |
| | | |
| Liabilities and Stockholders' Equity | | |
| Liabilities: | | |
| Non interest-bearing deposits | $ 40,297 | $ 48,056 |
| Interest-bearing deposits | 894,527 | 964,354 |
| Total deposits | 934,824 | 1,012,410 |
| | | |
| Borrowings | 480,714 | 479,335 |
| Accounts payable, accrued interest and other liabilities | 17,756 | 16,722 |
| Total liabilities | 1,433,294 | 1,508,467 |
| | | |
| Commitments and Contingencies | | |
| | | |
| Stockholders' equity: | | |
| Preferred stock, $.01 par value (2,000,000 shares authorized; none issued and outstanding) | - | - |
| Common stock, $.01 par value (15,000,000 shares authorized; 12,435,865 and 12,435,865 shares issued, respectively; 6,208,519 and 6,207,719 shares outstanding, respectively) | 124 | 124 |
| Additional paid-in capital | 74,943 | 75,164 |
| Retained earnings | 136,251 | 143,053 |
| Treasury stock at cost (6,227,346 and 6,228,146 shares, respectively) | (93,930) | (94,798) |
| Unearned stock compensation | - | (102) |
| Accumulated other comprehensive income, net of tax | 466 | 539 |

| | | | | |
|---|---|---|---|---|
| Total stockholders’ equity | | 117,854 | | 123,980 |
| Total liabilities and stockholders’ equity | $ | 1,551,148 | $ | 1,632,447 |

The accompanying notes are an integral part of these condensed consolidated financial statements.

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PROVIDENT FINANCIAL HOLDINGS, INC.
Condensed Consolidated Statements of Operations
(Unaudited)
In Thousands, Except Per Share Information

| | Quarter Ended December 31, 2008 | Quarter Ended December 31, 2007 | Six Months Ended December 31, 2008 | Six Months Ended December 31, 2007 |
|---|---|---|---|---|
| Interest income: | | | | |
| Loans receivable, net | $ 19,648 | $ 21,700 | $ 40,306 | $ 43,214 |
| Investment securities | 1,804 | 1,902 | 3,709 | 3,646 |
| FHLB – San Francisco stock | (125) | 432 | 324 | 901 |
| Interest-earning deposits | 9 | 5 | 10 | 14 |
| Total interest income | 21,336 | 24,039 | 44,349 | 47,775 |
| Interest expense: | | | | |
| Checking and money market deposits | 302 | 499 | 632 | 924 |
| Savings deposits | 535 | 804 | 1,104 | 1,591 |
| Time deposits | 5,441 | 7,888 | 11,568 | 15,946 |
| Borrowings | 4,817 | 5,280 | 9,511 | 10,373 |
| Total interest expense | 11,095 | 14,471 | 22,815 | 28,834 |
| Net interest income, before provision for loan losses | 10,241 | 9,568 | 21,534 | 18,941 |
| Provision for loan losses | 16,536 | 2,140 | 22,268 | 3,659 |
| Net interest (expense) income, after provision for loan losses | (6,295) | 7,428 | (734) | 15,282 |
| Non-interest income: | | | | |
| Loan servicing and other fees | 266 | 513 | 514 | 1,004 |
| Gain on sale of loans, net | 1,394 | 934 | 2,585 | 1,056 |
| Deposit account fees | 777 | 785 | 1,535 | 1,443 |
| Gain on sale of investment securities | - | - | 356 | - |
| Loss on sale and operations of real estate owned acquired in the settlement of loans | (496) | (704) | (886) | (1,008) |
| Other | 383 | 419 | 696 | 827 |
| Total non-interest income | 2,324 | 1,947 | 4,800 | 3,322 |
| Non-interest expense: | | | | |
| Salaries and employee benefits | 4,525 | 4,522 | 9,150 | 9,646 |
| Premises and occupancy | 718 | 831 | 1,434 | 1,538 |
| Equipment | 397 | 391 | 757 | 791 |
| Professional expenses | 332 | 474 | 692 | 793 |
| Sales and marketing expenses | 119 | 130 | 300 | 303 |
| | 288 | 115 | 610 | 230 |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Deposit insurance premiums and regulatory assessments | | | | | | | | |
| Other | | 860 | | 857 | | 1,660 | | 1,787 |
| Total non-interest expense | | 7,239 | | 7,320 | | 14,603 | | 15,088 |
| | | | | | | | | |
| (Loss) income before income taxes | | (11,210) | | 2,055 | | (10,537) | | 3,516 |
| (Benefit) provision for income taxes | | (4,699) | | 1,011 | | (4,355) | | 1,860 |
| Net (loss) income | $ | (6,511) | $ | 1,044 | $ | (6,182) | $ | 1,656 |
| | | | | | | | | |
| Basic (loss) earnings per share | $ | (1.05) | $ | 0.17 | $ | (1.00) | $ | 0.27 |
| Diluted (loss) earnings per share | $ | (1.05) | $ | 0.17 | $ | (1.00) | $ | 0.27 |
| Cash dividends per share | $ | 0.05 | $ | 0.18 | $ | 0.10 | $ | 0.36 |

The accompanying notes are an integral part of these condensed consolidated financial statements.

PROVIDENT FINANCIAL HOLDINGS, INC.
Condensed Consolidated Statements of Stockholders' Equity
(Unaudited)
Dollars in Thousands
For the Quarters Ended December 31, 2008 and 2007

| | Common Stock Shares | Common Stock Amount | Additional Paid-In Capital | Retained Earnings | Treasury Stock | Unearned Stock Compensation | Accumulated Other Comprehensive Income (Loss), Net of Tax | Total |
|---|---|---|---|---|---|---|---|---|
| Balance at October 1, 2008 | 6,208,519 | $ 124 | $ 74,635 | $ 143,072 | $ (93,930) | $ (22) | $ 622 | $ 124,501 |
| Comprehensive loss: | | | | | | | | |
| Net loss | | | | (6,511) | | | | (6,511) |
| Unrealized holding loss on securities available for sale, net of tax benefit of $113 | | | | | | | (156) | (156) |
| Total comprehensive loss | | | | | | | | (6,667) |
| Amortization of restricted stock | | | 113 | | | | | 113 |
| Stock options expense | | | 186 | | | | | 186 |
| Allocations of contribution to ESOP (1) | | | 9 | | | 22 | | 31 |
| Cash dividends | | | | (310) | | | | (310) |
| Balance at December 31, 2008 | 6,208,519 | $ 124 | $ 74,943 | $ 136,251 | $ (93,930) | $ - | $ 466 | $ 117,854 |

(1) Employee Stock Ownership Plan ("ESOP").

| | Common Stock Shares | Common Stock Amount | Additional Paid-In Capital | Retained Earnings | Treasury Stock | Unearned Stock Compensation | Accumulated Other Comprehensive Income, Net of Tax | Total |
|---|---|---|---|---|---|---|---|---|
| Balance at October 1, 2007 | 6,232,803 | $ 124 | $ 73,627 | $ 145,659 | $ (94,097) | $ (358) | $ 1,017 | $ 125,972 |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Comprehensive income: | | | | | | | | |
| Net income | | | | 1,044 | | | | 1,044 |
| Unrealized holding gain on securities available for sale, net of tax expense of $197 | | | | | | | 273 | 273 |
| Total comprehensive income | | | | | | | | 1,317 |
| | | | | | | | | |
| Purchase of treasury stock | (36,369) | | | | (700) | | | (700) |
| Amortization of restricted stock | | | 63 | | | | | 63 |
| Stock options expense | | | 136 | | | | | 136 |
| Allocations of contribution to ESOP | | | 354 | | | 97 | | 451 |
| Cash dividends | | | | (1,116) | | | | (1,116) |
| | | | | | | | | |
| Balance at December 31, 2007 | 6,196,434 | $ 124 | $ 74,180 | $ 145,587 | $ (94,797) | $ (261) | $ 1,290 | $ 126,123 |

The accompanying notes are an integral part of these condensed consolidated financial statements.

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PROVIDENT FINANCIAL HOLDINGS, INC.
Condensed Consolidated Statements of Changes in Stockholders' Equity
(Unaudited)
Dollars in Thousands
For the Six Months Ended December 31, 2008 and 2007

| | Common Stock Shares | Common Stock Amount | Additional Paid-In Capital | Retained Earnings | Treasury Stock | Unearned Stock Compensation | Accumulated Other Comprehensive Income (Loss), Net of Tax | Total |
|---|---|---|---|---|---|---|---|---|
| Balance at July 1, 2008 | 6,207,719 | $ 124 | $ 75,164 | $ 143,053 | $ (94,798) | $ ( 102) | $ 539 | $ 123,980 |
| Comprehensive loss: | | | | | | | | |
| Net loss | | | | (6,182) | | | | (6,182) |
| Unrealized holding loss on securities available for sale, net of tax benefit of $53 | | | | | | | (73) | (73) |
| Total comprehensive loss | | | | | | | | (6,255) |
| Distribution of restricted stock | 800 | | | | | | | - |
| Amortization of restricted stock | | | 208 | | | | | 208 |
| Awards of restricted stock | | | (868) | | 868 | | | - |
| Stock options expense | | | 369 | | | | | 369 |
| Allocations of contribution to ESOP | | | 70 | | | 102 | | 172 |
| Cash dividends | | | | (620) | | | | (620) |
| Balance at December 31, 2008 | 6,208,519 | $ 124 | $ 74,943 | $ 136,251 | $ (93,930) | $ - | $ 466 | $ 117,854 |

| | Common Stock Shares | Common Stock Amount | Additional Paid-In Capital | Retained Earnings | Treasury Stock | Unearned Stock Compensation | Accumulated Other Comprehensive Income, Net of Tax | Total |
|---|---|---|---|---|---|---|---|---|
| Balance at July 1, 2007 | 6,376,945 | $ 124 | | | ) | $ ( 455) | $ 693 | |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | | | $ 72,935 | $ 146,194 | $ (90,694 | | | $ 128,797 |
| Comprehensive income: | | | | | | | | |
| Net income | | | | 1,656 | | | | 1,656 |
| Unrealized holding gain on securities available for sale, net of tax expense of $432 | | | | | | | 597 | 597 |
| Total comprehensive income | | | | | | | | 2,253 |
| Purchase of treasury stock (1) | (188,011) | | | | (4,096) | | | (4,096) |
| Exercise of stock options | 7,500 | - | 69 | | | | | 69 |
| Amortization of restricted stock | | | 131 | | | | | 131 |
| Awards of restricted stock | | | (45) | | 45 | | | - |
| Forfeiture of restricted stock | | | 52 | | (52) | | | - |
| Stock options expense | | | 276 | | | | | 276 |
| Tax benefit from non-qualified equity compensation | | | 6 | | | | | 6 |
| Allocations of contribution to ESOP | | | 756 | | | 194 | | 950 |
| Cash dividends | | | | (2,263) | | | | (2,263) |
| Balance at December 31, 2007 | 6,196,434 | $ 124 | $ 74,180 | $ 145,587 | $ (94,797) | $ (261) | $ 1,290 | $ 126,123 |

(1) Includes the repurchase of 930 shares of distributed restricted stock.

The accompanying notes are an integral part of these condensed consolidated financial statements.

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PROVIDENT FINANCIAL HOLDINGS, INC.
Condensed Consolidated Statements of Cash Flows
(Unaudited - In Thousands)

| | Six Months Ended December 31, 2008 | 2007 |
|---|---|---|
| Cash flows from operating activities: | | |
| Net (loss) income | $ (6,182) | $ 1,656 |
| Adjustments to reconcile net (loss) income to net cash (used for) provided by operating activities: | | |
| Depreciation and amortization | 1,037 | 1,148 |
| Provision for loan losses | 22,268 | 3,659 |
| Provision for losses on real estate owned | 422 | 463 |
| Gain on sale of loans | (2,585) | (1,056) |
| Net gain on sale of investment securities | (356) | - |
| Net (gain) loss on sale of real estate owned | (439) | 168 |
| Stock-based compensation | 722 | 1,282 |
| FHLB – San Francisco stock dividend | (804) | (1,023) |
| Tax benefit from non-qualified equity compensation | - | (6) |
| Decrease in accounts payable and other liabilities | (520) | (2,876) |
| (Increase) decrease in prepaid expense and other assets | (6,063) | 2,465 |
| Loans originated for sale | (334,660) | (197,912) |
| Proceeds from sale of loans and net change in receivable from sale of loans | 320,071 | 240,317 |
| Net cash (used for) provided by operating activities | (7,089) | 48,285 |
| | | |
| Cash flows from investing activities: | | |
| Net decrease (increase) in loans held for investment | 60,763 | (53,766) |
| Maturity and call of investment securities held to maturity | - | 14,000 |
| Maturity and call of investment securities available for sale | 65 | 2,129 |
| Principal payments from mortgage-backed securities | 15,860 | 23,382 |
| Purchase of investment securities available for sale | (8,135) | (41,172) |
| Proceeds from sale of investment securities available for sale | 480 | - |
| Purchase of FHLB – San Francisco stock | - | (39) |
| Redemption of FHLB – San Francisco stock | - | 13,638 |
| Proceeds from sale of real estate owned | 17,937 | 3,709 |
| Purchase of premises and equipment | (662) | (144) |
| Net cash provided by (used for) investing activities | 86,308 | (38,263) |
| | | |
| Cash flows from financing activities: | | |
| Net (decrease) increase in deposits | (77,586) | 4,287 |
| (Repayments of) proceeds from short-term borrowings, net | (98,600) | 56,630 |
| Proceeds from long-term borrowings | 115,000 | 20,000 |
| Repayments of long-term borrowings | (15,021) | (85,020) |
| ESOP loan payment | 8 | 52 |
| Exercise of stock options | - | 69 |
| Tax benefit from non-qualified equity compensation | - | 6 |
| Cash dividends | (620) | (2,263) |

| | | |
|---|---|---|
| Treasury stock purchases | - | (4,096) |
| Net cash used for financing activities | (76,819) | (10,335) |
| | | |
| Net increase (decrease) in cash and cash equivalents | 2,400 | (313) |
| Cash and cash equivalents at beginning of period | 15,114 | 12,824 |
| | | |
| Cash and cash equivalents at end of period | $ 17,514 | $ 12,511 |
| Supplemental information: | | |
| Cash paid for interest | $ 22,380 | $ 29,250 |
| Cash paid for income taxes | $ 2,489 | $ 100 |
| Transfer of loans held for sale to loans held for investment | $ 707 | $ 8,467 |
| Real estate acquired in the settlement of loans | $ 26,151 | $ 8,393 |

The accompanying notes are an integral part of these condensed consolidated financial statements.

PROVIDENT FINANCIAL HOLDINGS, INC.
NOTES TO UNAUDITED INTERIM CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2008

Note 1: Basis of Presentation

The unaudited interim condensed consolidated financial statements included herein reflect all adjustments which are, in the opinion of management, necessary to present a fair statement of the results of operations for the interim periods presented. All such adjustments are of a normal, recurring nature. The condensed consolidated financial statements at June 30, 2008 are derived from the audited consolidated financial statements of Provident Financial Holdings, Inc. and its wholly owned subsidiary, Provident Savings Bank, F.S.B. (the "Bank") (collectively, the "Corporation"). Certain information and note disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been omitted pursuant to the rules and regulations of the Securities and Exchange Commission ("SEC") with respect to interim financial reporting. It is recommended that these unaudited interim condensed consolidated financial statements be read in conjunction with the audited consolidated financial statements and notes thereto included in the Corporation's Annual Report on Form 10-K for the year ended June 30, 2008. Certain amounts in the prior periods' financial statements have been reclassified to conform to the current period's presentation. The results of operations for the quarter and six months ended December 31, 2008 are not necessarily indicative of results that may be expected for the entire fiscal year ending June 30, 2009.

Note 2: Recent Accounting Pronouncements

Financial Accounting Standards Board ("FASB") Staff Position ("FSP") 133-1 and FASB Interpretation ("FIN") 45-4:
In September 2008, the FASB issued FSP No. 133-1 and FIN 45-4, "Disclosures about Credit Derivatives and Certain Guarantees: An Amendment of FASB Statement No. 133 and FASB Interpretation No. 45; and Clarification of the Effective Date of FASB Statement No. 161." The FSP is intended to improve disclosures about credit derivatives by requiring more information about the potential adverse effects of changes in credit risk on the financial position, financial performance, and cash flows of the sellers of credit derivatives. It amends SFAS No. 133 to require disclosures by sellers of credit derivatives, including credit derivatives embedded in hybrid instruments. The FSP also amends FIN 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness to Others," to require an additional disclosure about the current status of the payment/performance risk of a guarantee. Finally, the FSP clarifies the Board's intent about the effective date of SFAS No. 161. Accordingly, the FSP clarifies that the disclosures required by SFAS No. 161 will be incorporated upon adoption of SFAS No. 161 on July 1, 2009. The adoption of this FSP did not have material impact on the Corporation's consolidated financial statements.

Statement of Financial Accounting Standards ("SFAS" or "Statement") No. 162:
In May 2008, the FASB issued SFAS No. 162, "The Hierarchy of Generally Accepted Accounting Principles." The FASB believes the Generally Accepted Accounting Principal ("GAAP") hierarchy should be directed to entities because it is the entity (not its auditor) that is responsible for selecting accounting principles for financial statements that are presented in conformity with GAAP. Accordingly, the FASB concluded that the GAAP hierarchy should reside in the accounting literature established by the FASB and is issuing this Statement to achieve that result. The adoption of this Statement did not have a material impact on our consolidated financial statements.

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Note 3: Earnings (Loss) Per Share and Stock-Based Compensation

Earnings (Loss) Per Share:
Basic earnings per share ("EPS") excludes dilution and is computed by dividing income or loss available to common shareholders by the weighted-average number of 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 would then share in the earnings of the entity. As of December 31, 2008 and 2007, there were outstanding options to purchase 907,700 shares and 734,700 shares of the Corporation common stock, respectively, of which 907,700 shares and 597,000 shares, respectively, were excluded from the diluted EPS computation as their effect was anti-dilutive.

The following table provides the basic and diluted EPS computations for the quarters and six months ended December 31, 2008 and 2007, respectively.

| (In Thousands, Except Earnings (Loss) Per Share) | For the Quarter Ended December 31, 2008 | For the Quarter Ended December 31, 2007 | For the Six Months Ended December 31, 2008 | For the Six Months Ended December 31, 2007 |
|---|---|---|---|---|
| Numerator: | | | | |
| Net (loss) income – numerator for basic (loss) earnings per share and diluted (loss) earnings per share - available to common stockholders | $ (6,511) | $ 1,044 | $ (6,182) | $ 1,656 |
| Denominator: | | | | |
| Denominator for basic (loss) earnings per share: | | | | |
| Weighted-average shares | 6,204 | 6,134 | 6,195 | 6,187 |
| Effect of dilutive securities: | | | | |
| Stock option dilution | - | 64 | - | 57 |
| Restricted stock dilution | - | - | - | 1 |
| Denominator for diluted (loss) earnings per share: | | | | |
| Adjusted weighted-average shares and assumed conversions | 6,204 | 6,198 | 6,195 | 6,245 |
| Basic (loss) earnings per share | $ (1.05) | $ 0.17 | $ (1.00) | $ 0.27 |
| Diluted (loss) earnings per share | $ (1.05) | $ 0.17 | $ (1.00) | $ 0.27 |

SFAS No. 123R, "Share-Based Payment," requires companies to recognize in the statement of operations the grant-date fair value of stock options and other equity-based compensation issued to employees and directors. Effective July 1, 2005, the Corporation adopted SFAS No. 123R using the modified prospective method under which the provisions of SFAS No. 123R are applied to new awards and to awards modified, repurchased or cancelled after June 30, 2005 and to awards outstanding on June 30, 2005 for which requisite service has not yet been rendered.

The adoption of SFAS No. 123R resulted in incremental stock-based compensation expense and is solely related to issued and unvested stock option grants. The incremental stock-based compensation expense for the quarters ended December 31, 2008 and 2007 was $186,000 and $136,000, respectively. For the six months ended December 31, 2008 and 2007, the incremental stock-based compensation expense was $369,000 and $276,000, respectively. For the first six months of fiscal 2009 and 2008, cash provided by operating activities decreased by $0 and $6,000, respectively, and cash provided by financing activities increased by an identical amount, respectively, related to excess tax benefits from stock-based payment arrangements. These amounts are reflective of the tax benefit for stock options exercised and restricted stock distributions during the respective periods.

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Note 4: Operating Segment Reports

The Corporation operates in two business segments: community banking through the Bank and mortgage banking through Provident Bank Mortgage ("PBM"), a division of the Bank.

The following tables set forth condensed statements of operations and total assets for the Corporation's operating segments for the quarters ended December 31, 2008 and 2007, respectively (in thousands).

| | For the Quarter Ended December 31, 2008 | | |
|---|---|---|---|
| | Provident Bank | Provident Bank Mortgage | Consolidated Totals |
| Net interest income, before provision for loan losses | $ 10,195 | $ 46 | $ 10,241 |
| Provision for loan losses | 15,331 | 1,205 | 16,536 |
| Net interest expense, after provision for loan losses | (5,136) | (1,159) | (6,295) |
| Non-interest income: | | | |
| Loan servicing and other fees | 238 | 28 | 266 |
| Gain on sale of loans, net | 4 | 1,390 | 1,394 |
| Deposit account fees | 777 | - | 777 |
| Loss on sale and operations of real estate owned acquired in the settlement of loans, net | (307) | (189) | (496) |
| Other | 381 | 2 | 383 |
| Total non-interest income | 1,093 | 1,231 | 2,324 |
| Non-interest expense: | | | |
| Salaries and employee benefits | 3,276 | 1,249 | 4,525 |
| Premises and occupancy | 593 | 125 | 718 |
| Operating and administrative expenses | 1,180 | 816 | 1,996 |
| Total non-interest expense | 5,049 | 2,190 | 7,239 |
| Loss before taxes | (9,092) | (2,118) | (11,210) |
| Benefit for income taxes | (3,808) | (891) | (4,699) |
| Net loss | $ (5,284) | $ (1,227) | $ (6,511) |
| Total assets, end of period | $ 1,502,099 | $ 49,049 | $ 1,551,148 |

| | For the Quarter Ended December 31, 2007 | | |
|---|---|---|---|
| | Provident Bank | Provident Bank Mortgage | Consolidated Totals |
| Net interest income (expense), before provision for loan losses | $ 9,722 | $ (154) | $ 9,568 |
| Provision for loan losses | 1,098 | 1,042 | 2,140 |
| Net interest income (expense), after provision for loan losses | 8,624 | (1,196) | 7,428 |
| Non-interest income: | | | |
| Loan servicing and other fees (1) | 63 | 450 | 513 |
| Gain on sale of loans, net | 10 | 924 | 934 |
| Deposit account fees | 785 | - | 785 |
| Loss on sale and operations of real estate owned acquired in the settlement of loans, net | (204) | (500) | (704) |
| Other | 419 | - | 419 |
| Total non-interest income | 1,073 | 874 | 1,947 |
| Non-interest expense: | | | |
| Salaries and employee benefits | 3,321 | 1,201 | 4,522 |
| Premises and occupancy | 491 | 340 | 831 |
| Operating and administrative expenses | 926 | 1,041 | 1,967 |
| Total non-interest expense | 4,738 | 2,582 | 7,320 |
| Income (loss) before taxes | 4,959 | (2,904) | 2,055 |
| Provision (benefit) for income taxes | 2,386 | (1,375) | 1,011 |
| Net income (loss) | $ 2,573 | $ (1,529) | $ 1,044 |
| Total assets, end of period | $ 1,619,102 | $ 21,389 | $ 1,640,491 |

(1) Includes an inter-company charge of $352 credited to PBM by the Bank during the period to compensate PBM for originating loans held for investment.

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The following tables set forth condensed statements of operations and total assets for the Corporation's operating segments for the six months ended December 31, 2008 and 2007, respectively (in thousands).

| | For the Six Months Ended December 31, 2008 | | |
|---|---|---|---|
| | Provident Bank | Provident Bank Mortgage | Consolidated Totals |
| Net interest income, before provision for loan losses | $ 21,377 | $ 157 | $ 21,534 |
| Provision for loan losses | 20,209 | 2,059 | 22,268 |
| Net interest income (expense), after provision for loan losses | 1,168 | (1,902) | (734) |
| Non-interest income: | | | |
| Loan servicing and other fees (1) | 343 | 171 | 514 |
| Gain on sale of loans, net | 7 | 2,578 | 2,585 |
| Deposit account fees | 1,535 | - | 1,535 |
| Gain on sale of investment securities | 356 | - | 356 |
| Loss on sale and operations of real estate owned acquired in the settlement of loans, net | (620) | (266) | (886) |
| Other | 693 | 3 | 696 |
| Total non-interest income | 2,314 | 2,486 | 4,800 |
| Non-interest expense: | | | |
| Salaries and employee benefits | 6,666 | 2,484 | 9,150 |
| Premises and occupancy | 1,185 | 249 | 1,434 |
| Operating and administrative expenses | 2,310 | 1,709 | 4,019 |
| Total non-interest expense | 10,161 | 4,442 | 14,603 |
| Loss before taxes | (6,679) | (3,858) | (10,537) |
| Benefit for income taxes | (2,733) | (1,622) | (4,355) |
| Net loss | $ (3,946) | $ (2,236) | $ (6,182) |
| Total assets, end of period | $ 1,502,099 | $ 49,049 | $ 1,551,148 |

(1) Includes an inter-company charge of $102 credited to PBM by the Bank during the period to compensate PBM for originating loans held for investment.

| | For the Six Months Ended December 31, 2007 | | |
|---|---|---|---|
| | Provident Bank | Provident Bank Mortgage | Consolidated Totals |
| Net interest income (expense), before provision for loan losses | $ 19,106 | $ (165) | $ 18,941 |
| Provision for loan losses | 1,772 | 1,887 | 3,659 |
| Net interest income (expense), after provision for loan losses | 17,334 | (2,052) | 15,282 |
| Non-interest income: | | | |
| Loan servicing and other fees (1) | (1) | 1,005 | 1,004 |
| Gain on sale of loans, net | 33 | 1,023 | 1,056 |
| Deposit account fees | 1,443 | - | 1,443 |
| Loss on sale and operations of real estate owned acquired in the settlement of loans, net | (355) | (653) | (1,008) |
| Other | 827 | - | 827 |
| Total non-interest income | 1,947 | 1,375 | 3,322 |
| Non-interest expense: | | | |
| Salaries and employee benefits | 6,801 | 2,845 | 9,646 |
| Premises and occupancy | 1,041 | 497 | 1,538 |
| Operating and administrative expenses | 1,915 | 1,989 | 3,904 |
| Total non-interest expense | 9,757 | 5,331 | 15,088 |
| Income (loss) before taxes | 9,524 | (6,008) | 3,516 |
| Provision (benefit) for income taxes | 5,038 | (3,178) | 1,860 |
| Net income (loss) | $ 4,486 | $ (2,830) | $ 1,656 |
| Total assets, end of period | $ 1,619,102 | $ 21,389 | $ 1,640,491 |

(1) Includes an inter-company charge of $695 credited to PBM by the Bank during the period to compensate PBM for originating loans held for investment.

Note 5: Derivative and Other Financial Instruments with Off-Balance Sheet Risks

The Corporation is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit in the form of originating loans or providing funds under existing lines of credit, and forward loan sale agreements to third parties. These instruments involve, to varying degrees, elements of credit and interest-rate risk in excess of the amount recognized in the accompanying Condensed Consolidated Statements of Financial Condition. The Corporation's exposure to credit loss, in the event of non-performance by the counterparty to these financial instruments, is represented by the contractual amount of these instruments. The Corporation uses the same credit policies in entering into financial instruments with off-balance sheet risk as it does for on-balance sheet instruments. As of December 31, 2008 and June 30, 2008, the Corporation had commitments to extend credit (on loans to be held for investment and loans to be held for sale) of $46.2 million and $29.4 million, respectively. The following table provides information regarding undisbursed funds to borrowers on existing loans and lines of credit with the Bank as well as commitments to originate loans to be held for investment.

| Commitments<br>(In Thousands) | December 31, 2008 | June 30, 2008 |
|---|---|---|
| Undisbursed loan funds – Construction loans | $ 3,242 | $ 7,864 |
| Undisbursed lines of credit – Mortgage loans | 4,344 | 4,880 |
| Undisbursed lines of credit – Commercial business loans | 6,349 | 6,833 |
| Undisbursed lines of credit – Consumer loans | 1,545 | 1,672 |
| Commitments to extend credit on loans to be held for investment | 650 | 6,232 |
| Total | $ 16,130 | $ 27,481 |

In accordance with SFAS No. 133 and interpretations of the Derivatives Implementation Group of the FASB, the fair value of the commitments to extend credit on loans to be held for sale, loan sale commitments, commitments to purchase mortgage-backed securities ("MBS"), put option contracts and call option contracts are recorded at fair value on the balance sheet, and are included in other assets or other liabilities. The Corporation does not apply hedge accounting to its derivative financial instruments; therefore, all changes in fair value are recorded in earnings. The net impact of derivative financial instruments on the Condensed Consolidated Statements of Operations during the quarters ended December 31, 2008 and 2007 were a gain of $748,000 and a gain of $30,000, respectively. For the six months ended December 31, 2008 and 2007, the net impact of derivative financial instruments on the Condensed Consolidated Statements of Operations was a gain of $596,000 and a loss of $42,000, respectively.

| | December 31, 2008 | | June 30, 2008 | | December 31, 2007 | |
|---|---|---|---|---|---|---|
| Derivative Financial Instruments<br>(In Thousands) | Amount | Fair Value | Amount | Fair Value | Amount | Fair Value |
| Commitments to extend credit on loans to be held for sale (1) | $ 45,573 | $ 540 | $ 23,191 | $ (304) | $ 9,995 | $ (29) |
| Best-efforts loan sale commitments | (77,848) | - | (51,652) | - | (9,995) | - |
| Mandatory loan sale commitments | (34,712) | (248) | - | - | - | - |
| Total | $ (66,987) | $ 292 | $ (28,461) | $ (304) | $ - | $ (29) |

(1) Net of 41.0 percent at December 31, 2008, 48.0 percent at June 30, 2008 and 57.0 percent at December 31, 2007 of commitments, which may not fund.

Note 6: Income Taxes

FASB Interpretation 48, "Accounting for Uncertainty in Income Taxes," requires the affirmative evaluation that it is more likely than not, based on the technical merits of a tax position, that an enterprise is entitled to economic benefits resulting from positions taken in income tax returns. If a tax position does not meet the more-likely-than-not recognition threshold, the benefit of that position is not recognized in the financial statements. Management has determined that there are no unrecognized tax benefits to be reported in the Corporation's financial statements, and none are anticipated during the fiscal year ending June 30, 2009.

SFAS No. 109, "Accounting for Income Taxes," requires that when determining the need for a valuation allowance against a deferred tax asset, management must assess both positive and negative evidence with regard to the realizability of the tax losses represented by that asset. To the extent available sources of taxable income are insufficient to absorb tax losses, a valuation allowance is necessary. Sources of taxable income for this analysis include prior years' tax returns, the expected reversals of taxable temporary differences between book and tax income, prudent and feasible tax-planning strategies, and future taxable income. The Corporation's tax asset has increased during the first six months of fiscal 2009 due to an increase in its loan loss allowances. The deferred tax asset related to loan loss allowances will be realized when actual charge-offs are made against the loan loss allowances. Based on the availability of loss carry-backs and projected taxable income during the periods for which loss carry-forwards are available, management believes that no valuation allowance is necessary at this time.

The Corporation files income tax returns for the United States and state of California jurisdictions. In September 2008, the Internal Revenue Service ("IRS") completed its examination of the Corporation's tax returns for 2006 and 2007. Tax years subsequent to 2007 remain subject to federal examination, while the California state tax returns for years subsequent to 2004 are subject to examination by taxing authorities. It is the Corporation's policy to record any penalties or interest arising from federal or state taxes as a component of income tax expense. There were no penalties or interest included in the Condensed Consolidated Statements of Operations for the quarter and six months ended December 31, 2008.

Note 7: Fair Value of Financial Instruments

The Corporation adopted SFAS No. 157, "Fair Value Measurements," and SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities," on July 1, 2008. SFAS No. 157 defines fair value, establishes a framework for measuring fair value, and expands disclosures about fair value measurements. SFAS No. 159 permits entities to elect to measure many financial instruments and certain other assets and liabilities at fair value on an instrument-by-instrument basis (the Fair Value Option) at specified election dates. At each subsequent reporting date, an entity is required to report unrealized gains and losses on items in earnings for which the fair value option has been elected at each subsequent reporting date. The objective of the statement is to provide entities with the opportunity to mitigate volatility in earnings caused by measuring related assets and liabilities differently without having to apply complex accounting provisions. The Corporation did not elect to measure any financial instruments at fair value under SFAS No. 159. Under FSP 157-2, portions of SFAS No. 157 have been deferred until years beginning after November 15, 2008 for all nonfinancial assets and nonfinancial liabilities recognized or disclosed at fair value in the financial statement on a recurring basis. Therefore, the Corporation has partially adopted the provisions of SFAS No. 157.

In October 2008, the FASB issued FSP 157-3 – "Determining the Fair Value of a Financial Asset When the Market for that Asset is not Active." FSP 157-3 clarifies the application of SFAS No. 157 in a market that is not active and provides an example to illustrate key considerations in determining the fair value of a financial asset when the market for that financial asset is not active.

SFAS No. 157 establishes a three-level valuation hierarchy that prioritizes inputs to valuation techniques used in fair value calculations. The three levels of inputs are defined as follows:

Level-1 Unadjusted quoted prices in active markets for identical assets or liabilities that the Corporation has the ability to access at the measurement date.

Level-2 Observable inputs other than Level 1 such as: quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, or other inputs that are observable or can be corroborated to observable market data for substantially the full term of the asset or liability.

Level-3 Unobservable inputs for the asset or liability that use significant assumptions, including assumptions of risks. These unobservable assumptions reflect our own estimate of assumptions that market participants would use in pricing the asset or liability. Valuation techniques include use of pricing models, discounted cash flow models and similar techniques.

SFAS No. 157 requires the Corporation to maximize the use of observable inputs and minimize the use of unobservable inputs. If a financial instrument uses inputs that fall in different levels of the hierarchy, the instrument will be categorized based upon the lowest level of input that is significant to the fair value calculation.

The Corporation's financial assets and liabilities measured at fair value on a recurring basis consist of investment securities and derivative financial instruments, while loans held for sale and impaired loans are measured at fair value on a nonrecurring basis.

Investment securities are primarily comprised of U.S. government sponsored enterprise debt securities, U.S. government agency mortgage-backed securities, U.S. government sponsored enterprise mortgage-backed securities and private issue collateralized mortgage obligations. The Corporation utilizes unadjusted quoted prices in active markets for identical securities (Level 1) for its fair value measurement of debt securities, quoted prices in active and less than active markets for similar securities (Level 2) for its fair value measurement of mortgage-backed securities and broker price indications for similar securities in non-active markets (Level 3) for its fair value measurement of collateralized mortgage obligations (“CMO”).

Derivative financial instruments are comprised of commitments to extend credit on loans to be held for sale and mandatory loan sale commitments. The fair value is determined, when possible, using quoted secondary-market prices. If no such quoted price exists, the fair value of a commitment is determined by quoted prices for a similar commitment or commitments, adjusted for the specific attributes of each commitment.

Loans held for sale are primarily single-family loans. The fair value is determined, when possible, using quoted secondary-market prices. If no such quoted price exists, the fair value of a loan is determined by quoted prices for a similar loan or loans, adjusted for the specific attributes of each loan.

Impaired loans are loans which are inadequately protected by the current net worth and paying capacity of the borrowers or of the collateral pledged. The impaired loans are characterized by the distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected. The fair value of an impaired loan is determined based on an observable market price or current appraised value of the underlying collateral. Appraised and reported values may be discounted based on management’s historical knowledge, changes in market conditions from the time of valuation, and/or management’s expertise and knowledge of the borrower. Impaired loans are reviewed and evaluated on at least a quarterly basis for additional impairment and adjusted accordingly, based on the same factors identified above. This loss is not recorded directly as an adjustment to current earnings or comprehensive income, but rather as a component in determining the overall adequacy of the allowance for losses on loans. These adjustments to the estimated fair value of impaired loans may result in increases or decreases to the provision for losses on loans recorded in current earnings.

The Corporation’s valuation methodologies may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. While management believes the Corporation’s valuation methodologies are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different estimate of fair value at the reporting date.

The following fair value hierarchy table presents information about the Corporation’s assets measured at fair value on a recurring basis:

| | Fair Value Measurement at December 31, 2008 Using: | | | |
|---|---|---|---|---|
| (Dollars in Thousands) | Level 1 | Level 2 | Level 3 | Total |
| Investment securities | $ 5,377 | $ 137,798 | $ 1,756 | $ 144,931 |
| Derivative financial instruments | - | - | 292 | 292 |
| Total | $ 5,377 | $ 137,798 | $ 2,048 | $ 145,223 |

The following is a reconciliation of the beginning and ending balances of recurring fair value measurements recognized in the accompanying condensed consolidated statement of financial condition using Level 3 inputs:

| | Fair Value Measurement Using Significant Other Unobservable Inputs (Level 3) | | |
|---|---|---|---|
| (Dollars in Thousands) | CMO | Derivative Financial Instruments | Total |
| Beginning balance at October 1, 2008 | $ 2,003 | $ (456) | $ 1,547 |
| Total gains or losses (realized/unrealized): | | | |
| Included in earnings (or changes in net assets) | - | 456 | 456 |
| Included in other comprehensive income | (176) | - | (176) |
| Purchases, issuances, and settlements | (71) | 292 | 221 |
| Transfers in and/or out of Level 3 | - | - | - |
| Ending balance at December 31, 2008 | $ 1,756 | $ 292 | $ 2,048 |

| | Fair Value Measurement Using Significant Other Unobservable Inputs (Level 3) | | |
|---|---|---|---|
| (Dollars in Thousands) | CMO | Derivative Financial Instruments | Total |
| Beginning balance at July 1, 2008 | $ 2,225 | $ (304) | $ 1,921 |
| Total gains or losses (realized/unrealized): | | | |
| Included in earnings (or changes in net assets) | - | 760 | 760 |
| Included in other comprehensive income | (176) | - | (176) |
| Purchases, issuances, and settlements | (293) | (164) | (457) |
| Transfers in and/or out of Level 3 | - | - | - |
| Ending balance at December 31, 2008 | $ 1,756 | $ 292 | $ 2,048 |

The following fair value hierarchy table presents information about the Corporation’s assets measured at fair value on a nonrecurring basis:

| | Fair Value Measurement at December 31, 2008 Using: | | | |
|---|---|---|---|---|
| (Dollars in Thousands) | Level 1 | Level 2 | Level 3 | Total |
| Loans held for sale | $ - | $ 487 | $ - | $ 487 |
| Impaired loans (1) | - | - | 45,733 | 45,733 |
| Total | $ - | $ 487 | $ 45,733 | $ 46,220 |

(1) The fair value of the impaired loans are derived from their respective collateral values.

Note 8: Subsequent Events

On January 20, 2009, the Corporation announced a cash dividend of $0.03 per share on the Corporation's outstanding shares of common stock for shareholders of record as of the close of business on February 10, 2009, payable on March 6, 2009.

ITEM 2 – Management's Discussion and Analysis of Financial Condition and Results of Operations

General

Provident Financial Holdings, Inc., a Delaware corporation, was organized in January 1996 for the purpose of becoming the holding company of Provident Savings Bank, F.S.B. upon the Bank's conversion from a federal mutual to a federal stock savings bank ("Conversion"). The Conversion was completed on June 27, 1996. At December 31, 2008, the Corporation had total assets of $1.55 billion, total deposits of $934.8 million and total stockholders' equity of $117.9 million. The Corporation has not engaged in any significant activity other than holding the stock of the Bank. Accordingly, the information set forth in this report, including financial statements and related data, relates primarily to the Bank and its subsidiaries.

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

The Bank's business consists of community banking activities and mortgage banking activities. Community banking activities primarily consist of accepting deposits from customers within the communities surrounding the Bank's full service offices and investing those funds in single-family loans, multi-family loans, commercial real estate loans, construction loans, commercial business loans, consumer loans and other real estate loans. The Bank also offers business checking accounts, other business banking services, and services loans for others. Mortgage banking activities consist of the origination and sale of mortgage and consumer loans secured primarily by single-family residences. The Bank currently operates 14 retail/business banking offices in Riverside County and San Bernardino County (commonly known as the Inland Empire), including the newly opened Iris Plaza office in Moreno Valley, California. Provident Bank Mortgage operates wholesale loan production offices in Pleasanton and Rancho Cucamonga, California and retail loan production offices in Glendora and Riverside, California. The Bank's revenues are derived principally from interest on its loans and investment securities and fees generated through its community banking and mortgage banking activities. There are various risks inherent in the Bank's business including, among others, the general business environment, interest rates, the California real estate market, the demand for loans, the prepayment of loans, the repurchase of loans previously sold to investors, competitive conditions between banks and non-bank financial services providers, legislative and regulatory changes, fraud and other risks.

The Corporation, from time to time, may repurchase its common stock. The Corporation evaluates the repurchase of its common stock when the market price of the stock is lower than its book value and/or the Corporation believes that the current market price is not commensurate with its current and future earnings potential. Consideration is also given to the Corporation's liquidity, regulatory capital requirements and future capital needs based on the Corporation's current business plan. The Corporation's Board of Directors authorizes each stock repurchase program, the duration of which is typically one year. Once the stock repurchase program is authorized, management may repurchase the Corporation's common stock from time to time in the open market or in privately negotiated transactions, depending upon market conditions and the factors described above. On June 26, 2008, the Corporation announced that its Board of Directors authorized the repurchase of up to five percent of its outstanding common stock, or approximately 310,385 shares, over a one-year period. As a result of current economic conditions, the Corporation did not repurchase any of its shares during the quarter ended December 31, 2008. See Part II, Item 2 – "Unregistered Sales of Equity Securities and Use of Proceeds" on page 49.

The Corporation began to distribute quarterly cash dividends in the quarter ended September 30, 2002. On October 30, 2008, the Corporation declared a quarterly cash dividend of $0.05 per share for the Corporation's shareholders of record at the close of business on November 21, 2008, which was paid on December 16, 2008. On January 20, 2009, the Corporation declared a cash dividend of $0.03 per share on the Corporation's outstanding shares of common stock for shareholders of record as of the close of business on February 10, 2009, payable on March 6, 2009. Future declarations or payments of dividends will be subject to the consideration of the Corporation's Board of Directors, which will take into account the Corporation's financial condition, results of operations, tax considerations, capital requirements, industry standards, legal restrictions, economic conditions and other factors, including the regulatory restrictions which affect the payment of dividends by the Bank to the Corporation. Under Delaware law, dividends may be paid either out of surplus or, if there is no surplus, out of net profits for the current fiscal year and/or the preceding fiscal year in which the dividend is declared.

Management's Discussion and Analysis of Financial Condition and Results of Operations is intended to assist in understanding the financial condition and results of operations of the Corporation.  The information contained in this section should be read in conjunction with the Unaudited Interim Condensed Consolidated Financial Statements and accompanying selected Notes to Unaudited Interim Condensed Consolidated Financial Statements.

Safe-Harbor Statement

This Form 10-Q contains statements that the Corporation believes are "forward-looking statements." These statements relate to the Corporation's financial condition, results of operations, plans, objectives, future performance or business. You should not place undue reliance on these statements, as they are subject to risks and uncertainties. When considering these forward-looking statements, you should keep in mind these risks and uncertainties, as well as any cautionary statements the Corporation may make. Moreover, you should treat these statements as speaking only as of the date they are made and based only on information then actually known to the Corporation. There are a number of important factors that could cause future results to differ materially from historical performance and these forward-looking statements. Factors which could cause actual results to differ materially include, but are not limited to, the credit risks of lending activities, including changes in the level and trend of loan delinquencies and write-offs; changes in general economic conditions, either nationally or in our market areas; changes in the levels of general interest rates, deposit interest rates, our net interest margin and funding sources; fluctuations in the demand for loans, the number of unsold homes and other properties and fluctuations in real estate values in our market areas; results of examinations of us by the Office of Thrift Supervision, Federal Deposit Insurance Corporation or other regulatory authorities, including the possibility that any such regulatory authority may, among other things, require us to increase our reserve for loan losses or to write-down assets; our ability to control operating costs and expenses; our ability to successfully integrate any assets, liabilities, customers, systems, and management personnel we have acquired or may in the future acquire into our operations and our ability to realize related revenue synergies and cost savings within expected time frames and any goodwill charges related thereto; our ability to manage loan delinquency rates; our ability to retain key members of our senior management team; costs and effects of litigation, including settlements and judgments; increased competitive pressures among financial services companies; changes in consumer spending, borrowing and savings habits; legislative or regulatory changes that adversely affect our business; adverse changes in the securities markets; inability of key third-party providers to perform their obligations to us; changes in accounting policies and practices, as may be adopted by the financial institution regulatory agencies or the Financial Accounting Standards Board; war or terrorist activities; other economic, competitive, governmental, regulatory, and technological factors affecting our operations, pricing, products and services and other risks detailed in the Corporation's reports filed with the Securities and Exchange Commission, including its Annual Report on Form 10-K for the fiscal year ended June 30, 2008.

Critical Accounting Policies

The discussion and analysis of the Corporation's financial condition and results of operations are based upon the Corporation's condensed consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires management to make estimates and judgments that affect the reported amounts of assets and liabilities, revenues and expenses, and related disclosures of contingent assets and liabilities at the date of the financial statements. Actual results may differ from these estimates under different assumptions or conditions.

Allowance for loan losses involves significant judgment and assumptions by management, which have a material impact on the carrying value of net loans. Management considers this accounting policy to be a critical accounting policy. The allowance is based on two principles of accounting: (i) SFAS No. 5, "Accounting for Contingencies," which requires that losses be accrued when they are probable of occurring and can be estimated; and (ii) SFAS No. 114, "Accounting by Creditors for Impairment of a Loan," and SFAS No. 118, "Accounting by Creditors for Impairment of a Loan-Income Recognition and Disclosures," which require that losses be accrued based on the differences between the value of collateral, present value of future cash flows or values that are observable in the secondary market and the loan balance. The allowance has two components: a formula allowance for groups of homogeneous loans and a specific valuation allowance for identified problem loans. Each of these components is based upon estimates that can change over time. The formula allowance is based primarily on historical experience and as a result can differ from actual losses incurred in the future. The history is reviewed at least quarterly and adjustments are made as needed. Various techniques are used to arrive at specific loss estimates, including historical loss information, discounted cash flows and the fair market value of collateral. The use of these techniques is inherently subjective and the actual losses could be greater or less than the estimates.

Interest is not accrued on any loan when its contractual payments are more than 90 days delinquent or if the loan is deemed impaired. In addition, interest is not recognized on any loan where management has determined that collection is not reasonably assured. A non-accrual loan may be restored to accrual status when delinquent principal and interest payments are brought current and future monthly principal and interest payments are expected to be collected.

SFAS No. 133, "Accounting for Derivative Financial Instruments and Hedging Activities," requires that derivatives of the Corporation be recorded in the consolidated financial statements at fair value. Management considers this accounting policy to be a critical accounting policy. The Bank's derivatives are primarily the result of its mortgage banking activities in the form of commitments to extend credit, commitments to sell loans, commitments to purchase MBS and option contracts to mitigate the risk of the commitments to extend credit. Estimates of the percentage of commitments to extend credit on loans to be held for sale that may not fund are based upon historical data and current market trends. The fair value adjustments of the derivatives are recorded in the consolidated statements of operations with offsets to other assets or other liabilities in the consolidated statements of financial condition.

Management accounts for income taxes by estimating future tax effects of temporary differences between the tax and book basis of assets and liabilities considering the provisions of enacted tax laws. These differences result in deferred tax assets and liabilities, which are included in the Corporation's Condensed Consolidated Statements of Financial Condition. Management's judgment is required in determining the amount and timing of recognition of the resulting deferred tax assets and liabilities, including projections of future taxable income. Therefore, management considers its accounting for income taxes a critical accounting policy.

Executive Summary and Operating Strategy

Provident Savings Bank, F.S.B., established in 1956, is a financial services company committed to serving consumers and small to mid-sized businesses in the Inland Empire region of Southern California. The Bank conducts its business operations as Provident Bank, Provident Bank Mortgage, a division of the Bank, and through its subsidiary, Provident Financial Corp. The business activities of the Corporation, primarily through the Bank and its subsidiary, consist of community banking, mortgage banking, and to a lesser degree, investment services for customers and trustee services on behalf of the Bank.

Community banking operations primarily consist of accepting deposits from customers within the communities surrounding the Bank's full service offices and investing those funds in single-family, multi-family, commercial real estate, construction, commercial business, consumer and other loans. Additionally, certain fees are collected from depositors, such as returned check fees, deposit account service charges, ATM fees, IRA/KEOGH fees, safe deposit box fees, travelers check fees, and wire transfer fees, among others. The primary source of income in community banking is net interest income, which is the difference between the interest income earned on loans and investment securities, and the interest expense paid on interest-bearing deposits and borrowed funds. During the next three years, although not immediately given the uncertain environment, the Corporation intends to improve the community banking business by moderately growing total assets; by decreasing the concentration of single-family mortgage loans within loans held for investment; and by increasing the concentration of higher yielding multi-family, commercial real estate, construction and commercial business loans (which are sometimes referred to in this report as "preferred loans"). In addition, over time, the Corporation intends to decrease the percentage of time deposits in its deposit base and to increase the percentage of lower cost checking and savings accounts. This strategy is intended to improve core revenue through a higher net interest margin and ultimately, coupled with the growth of the Corporation, an increase in net interest income. While the Corporation's long-term strategy described moderate growth, management may determine from time to time that shrinking the balance sheet is the most prudent short-term strategy in response to deteriorating general economic conditions.

Mortgage banking operations primarily consist of the origination and sale of mortgage loans secured by single-family residences. The primary sources of income in mortgage banking are gain on sale of loans and certain fees collected from borrowers in connection with the loan origination process. The Corporation will continue to restructure its operations in response to the rapidly changing mortgage banking environment. Changes may include a different product mix, further tightening of underwriting standards, a further reduction in its operating expenses or a combination of these and other changes.

Investment services operations primarily consist of selling alternative investment products such as annuities and mutual funds to the Bank's depositors. Provident Financial Corp performs trustee services for the Bank's real estate secured loan transactions and has in the past held, and may in the future hold, real estate for investment. Investment services and trustee services contribute a very small percentage of gross revenue.

There are a number of risks associated with the business activities of the Corporation, many of which are beyond the Corporation's control, including: changes in accounting principles, changes in regulation and changes in the economy, among others. The Corporation attempts to mitigate many of these risks through prudent banking practices such as interest rate risk management, credit risk management, operational risk management, and liquidity management. The current economic environment presents heightened risk for the Corporation primarily with respect to falling real estate values and higher loan delinquencies. Declining real estate values may lead to higher loan losses since the majority of the Corporation's loans are secured by real estate located within California. Significant declines in the value of California real estate may inhibit the Corporation's ability to recover on defaulted loans by selling the underlying real estate. For further details on risk factors, see the Safe-Harbor Statement on page 17 and Item 1A – Risk Factors on page 45.

Off-Balance Sheet Financing Arrangements and Contractual Obligations

The following table summarizes the Corporation's contractual obligations at December 31, 2008 and the effect these obligations are expected to have on the Corporation's liquidity and cash flows in future periods (in thousands):

| | Payments Due by Period | | | | |
|---|---|---|---|---|---|
| | 1 year or less | Over 1 year to 3 years | Over 3 years to 5 years | Over 5 years | Total |
| Operating obligations | $ 795 | $ 930 | $ 447 | $ - | $ 2,172 |
| Time deposits | 559,808 | 51,350 | 20,114 | 75 | 631,347 |
| FHLB – San Francisco advances | 146,127 | 229,954 | 130,918 | 19,268 | 526,267 |
| FHLB – San Francisco letter of credit | 2,500 | - | - | - | 2,500 |
| Total | $ 709,230 | $ 282,234 | $ 151,479 | $ 19,343 | $ 1,162,286 |

The expected obligation for time deposits and FHLB – San Francisco advances include anticipated interest accruals based on the respective contractual terms.

In addition to the off-balance sheet financing arrangements and contractual obligations mentioned above, the Corporation has derivatives and other financial instruments with off-balance sheet risks as described in Note 5 of the Notes to Unaudited Interim Consolidated Financial Statements on page 11.

Comparison of Financial Condition at December 31, 2008 and June 30, 2008

Total assets decreased $81.3 million, or five percent, to $1.55 billion at December 31, 2008 from $1.63 billion at June 30, 2008.  The decrease was primarily attributable to a decrease in loans held for investment.

Loans held for investment decreased $102.7 million, or eight percent, to $1.27 billion at December 31, 2008 from $1.37 billion at June 30, 2008.  During the first six months of fiscal 2009, the Bank originated $17.2 million of loans held for investment, of which $7.4 million, or 43 percent, were “preferred loans” (multi-family, commercial real estate, construction and commercial business loans). The Bank did not purchase any loans for investment in the first six months of fiscal 2009, resulting from the Corporation's decision to compete less aggressively for origination volume given the economic uncertainty of the current banking environment. Total loan principal payments during the first six months of fiscal 2009 were $89.7 million, compared to $134.7 million during the comparable period in fiscal 2008. The balance of preferred loans decreased to $528.5 million, or 41 percent of loans held for investment at December 31, 2008, as compared to $569.6 million, or 41 percent of loans held for investment at June 30, 2008. Purchased loans serviced by others at December 31, 2008 were $132.7 million, or 10 percent of loans held for investment, compared to $146.5 million, or 11 percent of loans held for investment at June 30, 2008.

The table below describes the geographic dispersion of real estate secured loans held for investment at December 31, 2008, as a percentage of the total dollar amount outstanding:

| Loan Category | Inland Empire Balance | % | Southern California (1) Balance | % | Other California Balance | % | Other States Balance | % | Total Balance | % |
|---|---|---|---|---|---|---|---|---|---|---|
| Single-family | $231,011 | 31% | $413,528 | 54% | $105,945 | 14% | $10,605 | 1% | $761,089 | 100% |
| Multi-family | 34,928 | 9% | 267,744 | 70% | 72,797 | 19% | 6,119 | 2% | 381,588 | 100% |
| Commercial real estate | 60,045 | 47% | 63,402 | 50% | 2,387 | 2% | 1,655 | 1% | 127,489 | 100% |
| Construction | 11,908 | 97% | 400 | 3% | - | 0% | - | 0% | 12,308 | 100% |
| Other | 3,289 | 100% | - | 0% | - | 0% | - | 0% | 3,289 | 100% |
| Total | $341,181 | 27% | $745,074 | 58% | $181,129 | 14% | $18,379 | 1% | $1,285,763 | 100% |

(1) Other than the Inland Empire.

Total loans held for sale increased $17.9 million, or 63 percent, to $46.4 million at December 31, 2008 from $28.5 million at June 30, 2008. The increase was due primarily to the timing difference between loan originations and loan sale settlements. See "Loan Volume Activities" on page 36.

Total investment securities decreased $8.2 million, or five percent, to $144.9 million at December 31, 2008 from $153.1 million at June 30, 2008. The decrease was primarily the result of scheduled and accelerated principal payments on mortgage-backed securities. The Bank evaluates individual investment securities quarterly for other-than-temporary declines in market value. The Bank does not believe that there are any other-than-temporary impairments at December 31, 2008; therefore, no impairment losses have been recorded as of December 31, 2008.

Total deposits decreased $77.6 million, or eight percent, to $934.8 million at December 31, 2008 from $1.01 billion at June 30, 2008. This decrease was primarily attributable to the strategic decision to compete less aggressively on time deposit interest rates, partly offset by the Bank's marketing strategy to promote transaction accounts.

Borrowings, consisting of FHLB – San Francisco advances increased slightly to $480.7 million at December 31, 2008 from $479.3 million at June 30, 2008. The increase in borrowings was primarily the result of the decrease in deposits and the increase in loans held for sale, partly offset by the decrease in loans held for investment. The weighted-average maturity of the Bank's FHLB – San Francisco advances was approximately 29 months (27 months, if put options are exercised by the FHLB – San Francisco) at December 31, 2008, as compared to the weighted-average maturity of 23 months (20 months, if put options were exercised by the FHLB – San Francisco) at June 30, 2008.

Total stockholders' equity decreased $6.1 million, or five percent, to $117.9 million at December 31, 2008, from $124.0 million at June 30, 2008, primarily as a result of the net loss and the quarterly cash dividends paid during the first six months of fiscal 2009. No stock options were exercised and no common stock was repurchased during the first six months of fiscal 2009. The total cash dividend paid to the Corporation's shareholders in the first six months of fiscal 2009 was $620,000.

Comparison of Operating Results for the Quarters and Six Months Ended December 31, 2008 and 2007

The Corporation's net loss for the quarter ended December 31, 2008 was $6.5 million, compared to net income of $1.0 million during the same quarter of fiscal 2008. For the six months ended December 31, 2008, the Corporation's net loss was $6.2 million, compared to net income of $1.7 million during the same period of fiscal 2008. The decrease for both periods was primarily a result of the increase in the provision for loan losses, partly offset by the increase in net interest income (before provision for loan losses), the increase in non-interest income and the decrease in operating expenses.

The Corporation's efficiency ratio improved to 58 percent in the second quarter of fiscal 2009 from 64 percent in the same period of fiscal 2008. For the six months ended December 31, 2008, the efficiency ratio improved to 55 percent from 68 percent in the six months ended December 31, 2007. The improvement in the efficiency ratio for both these periods was a result of the increase in net interest income (before provision for loan losses), the increase in non-interest income and the decrease in non-interest expenses.

Return on average assets for the quarter ended December 31, 2008 decreased 193 basis points to (1.67) percent from 0.26 percent in the same period last year. For the six months ended December 31, 2008 and 2007, the return on average assets was (0.78) percent and 0.21 percent, respectively, a decrease of 99 basis points.

Return on average equity for the quarter ended December 31, 2008 decreased to (21.44) percent from 3.30 percent for the same period last year. For the six months ended December 31, 2008, the return on average equity decreased to (10.07) percent from 2.60 percent for the same period last year.

Diluted earnings per share for the quarter ended December 31, 2008 were $(1.05), compared to $0.17 for the quarter ended December 31, 2007. For the six months ended December 31, 2008 and 2007, diluted earnings per share were $(1.00) and $0.27, respectively.

Net Interest Income:

For the Quarters Ended December 31, 2008 and 2007. The Corporation's net interest income (before the provision for loan losses) increased by $673,000, or seven percent, to $10.2 million for the quarter ended December 31, 2008 from $9.6 million in the comparable period in fiscal 2008. This increase was the result of a higher net interest margin, partly offset by lower average earning assets. The net interest margin increased to 2.70 percent in the second quarter of fiscal 2009, up 28 basis points from 2.42 percent for the same period of fiscal 2008. The increase in the net interest margin during the second quarter of fiscal 2009 was primarily attributable to a decrease in the average cost of funds which declined more than the average yield on earning assets. The average balance of earning assets decreased $66.3 million to $1.52 billion in the second quarter of fiscal 2009 from $1.58 billion in the comparable period of fiscal 2008.

For the Six Months Ended December 31, 2008 and 2007. Net interest income (before the provision for loan losses) for the first six months of fiscal 2009 was $21.5 million, up $2.6 million or 14 percent from $18.9 million during the same period of fiscal 2008. This increase was the result of a higher net interest margin, partly offset by lower average earning assets. The net interest margin increased to 2.79 percent in the first six months of fiscal 2009, up 38 basis points from 2.41 percent during the same period of fiscal 2008. The increase in the net interest margin during the first six months of fiscal 2009 was primarily attributable to a decrease in the average cost of funds which decreased more than the average yield on earning assets, which remained relatively stable, coupled with the lower average balance of interest earning assets. The average balance of earning assets decreased $28.7 million, or two percent, to $1.54 billion in the first six months of fiscal 2009 from $1.57 billion in the comparable period of fiscal 2008.

Interest Income:

For the Quarters Ended December 31, 2008 and 2007. Total interest income decreased by $2.7 million, or 11 percent, to $21.3 million for the second quarter of fiscal 2009 from $24.0 million in the same quarter of fiscal 2008. This decrease was primarily the result of a lower average earning asset yield and a lower average balance of earning assets. The average yield on earning assets during the second quarter of fiscal 2009 was 5.62 percent, 45 basis points lower than the average yield of 6.07 percent during the same period of fiscal 2008.

Loans receivable interest income decreased $2.1 million, or 10 percent, to $19.6 million in the quarter ended December 31, 2008 from $21.7 million for the same quarter of fiscal 2008. This decrease was attributable to a lower average loan yield and a lower average loan balance. The average loan yield during the second quarter of fiscal 2009 decreased 28 basis points to 5.93 percent from 6.21 percent during the same quarter last year. The decrease in the average loan yield was primarily attributable to accrued interest reversals from newly classified non-accrual loans and loan payoffs which carried a higher average yield than the average yield of loans receivable. The average balance of loans outstanding, including loans held for sale, decreased $72.6 million, or five percent, to $1.33 billion during the second quarter of fiscal 2009 from $1.40 billion in the same quarter of fiscal 2008.

Interest income from investment securities decreased $98,000, or five percent, to $1.8 million during the quarter ended December 31, 2008 from $1.9 million in the same quarter of fiscal 2008. The decrease was primarily a result of a decrease in average yield and a decrease in the average balance. The average yield on investment securities decreased 12 basis points to 4.83 percent during the quarter ended December 31, 2008 from 4.95 percent during the quarter ended December 31, 2007. The decrease in the average yield of investment securities was primarily attributable to the net premium amortization of $24,000 in the second quarter of fiscal 2009 as compared to the net discount amortization of $4,000 in the comparable quarter of fiscal 2008. During the second quarter of fiscal 2009, the Bank did not purchase any investment securities, while $7.5 million of principal payments were received on mortgage-backed securities. The average balance of investment securities decreased $4.5 million, or three percent, to $149.3 million in the second quarter of fiscal 2009 from $153.8 million in the same quarter of fiscal 2008.

FHLB – San Francisco stock dividends were $(125,000) in the second quarter of fiscal 2009, down from $432,000 in the same period of fiscal 2008. The decline was primarily attributable to the FHLB announcement that they will not pay a dividend for the quarter ended December 31, 2008 and an accrual adjustment resulting from a lower actual dividend received in November 2008 than accrued for the relevant period.

For the Six Months Ended December 31, 2008 and 2007. Total interest income decreased by $3.5 million, or seven percent, to $44.3 million for the first six months of fiscal 2009 from $47.8 million in the same period of fiscal 2008. This decrease was primarily the result of a lower average balance of earning assets and a lower average earning asset yield. The average yield on earning assets during the first six months of fiscal 2009 was 5.75 percent, 33 basis points lower than the average yield of 6.08 percent during the same period of fiscal 2008.

Loans receivable interest income decreased $2.9 million, or seven percent, to $40.3 million in the six months ended December 31, 2008 from $43.2 million for the same period of fiscal 2008. This decrease was attributable to a lower average loan balance and a lower average loan yield. The average balance of loans outstanding, including the receivable from sale of loans and loans held for sale, decreased $36.0 million, or three percent, to $1.35 billion during the first six months of fiscal 2009 from $1.39 billion during the same period of fiscal 2008. The average loan yield during the first six months of fiscal 2009 decreased 26 basis points to 5.97 percent from 6.23 percent during the same period last year. The decrease in the average loan yield was primarily attributable to accrued interest reversals from newly classified non-accrual loans and loan payoffs which carried a higher average yield than the average yield of loans receivable.

Interest income from investment securities increased $63,000 to $3.7 million during the six months ended December 31, 2008 from $3.6 million in the same period of fiscal 2008. This increase was primarily a result of an increase in average yield and an increase in the average balance. The average yield on the investment securities increased seven basis points to 4.88 percent during the six months ended December 31, 2008 from 4.81 percent during the six months ended December 31, 2007. The average balance of investment securities increased $418,000, or less than one percent, to $152.0 million in the first six months of fiscal 2009 from $151.6 million in the same period of fiscal 2008. During the first six months of fiscal 2009, $8.1 million of investment securities were purchased, while $15.9 million of principal payments were received on mortgage-backed securities.

FHLB – San Francisco stock dividends decreased by $577,000, or 64 percent, to $324,000 in the first six months of fiscal 2009 from $901,000 in the same period of fiscal 2008. This decrease was attributable to a lower average yield and a lower average balance in the amount of FHLB – San Francisco stock. The average yield on FHLB – San Francisco stock decreased 348 basis points to 1.99 percent during the first six months of fiscal 2009 from 5.47 percent during the same period last year. The decrease in the average yield was primarily attributable to the FHLB – San Francisco announcement on January 8, 2009 that they would not pay a dividend for the quarter ended December 31, 2008. The average balance of FHLB – San Francisco stock decreased $378,000 to $32.6 million during the first six months of fiscal 2009 from $33.0 million during the same period of fiscal 2008. The average balance of FHLB – San Francisco stock was consistent with the borrowing requirements of the FHLB – San Francisco.

Interest Expense:

For the Quarters Ended December 31, 2008 and 2007. Total interest expense for the quarter ended December 31, 2008 was $11.1 million as compared to $14.5 million for the same period of fiscal 2008, a decrease of $3.4 million, or 23 percent. This decrease was primarily attributable to a lower average cost of interest-bearing liabilities and a lower average balance. The average cost of interest-bearing liabilities was 3.12 percent during the quarter ended December 31, 2008, down 78 basis points from 3.90 percent during the same period of fiscal 2008. The average balance of interest-bearing liabilities, principally deposits and borrowings, decreased $59.9 million, or four percent, to $1.41 billion during the second quarter of fiscal 2009 from $1.47 billion during the same period of fiscal 2008.

Interest expense on deposits for the quarter ended December 31, 2008 was $6.3 million as compared to $9.2 million for the same period of fiscal 2008, a decrease of $2.9 million, or 32 percent. The decrease in interest expense on deposits was primarily attributable to a lower average cost and a lower average balance. The average cost of deposits decreased to 2.66 percent during the quarter ended December 31, 2008 from 3.62 percent during the same quarter of fiscal 2008, a decrease of 96 basis points. The decrease in the average cost of deposits was attributable primarily to new time deposits with a lower average cost, replacing maturing time deposits with a higher average cost, consistent with declining short-term interest rates. The average balance of deposits decreased $70.8 million, or seven percent, to $937.5 million during the quarter ended December 31, 2008 from $1.01 billion during the same period of fiscal 2008. The decline in the average balance was primarily in time deposits, the result of the Bank’s strategic decision to compete less aggressively for this product. The average balance of transaction account deposits to total deposits in the second quarter of fiscal 2009 was unchanged at 34 percent, compared to the same period of fiscal 2008.

Interest expense on borrowings, consisting primarily of FHLB – San Francisco advances, for the quarter ended December 31, 2008 decreased $463,000, or nine percent, to $4.8 million from $5.3 million for the same period of fiscal 2008. The decrease in interest expense on borrowings was primarily a result of a lower average cost, partly offset by a higher average balance. The average cost of borrowings decreased to 4.02 percent for the quarter ended December 31, 2008 from 4.50 percent in the same quarter of fiscal 2008, a decrease of 48 basis points. The decrease in the average cost of borrowings was primarily the result of maturing long-term advances which had a higher average cost than the average cost of new advances. Additionally, short-term advance interest rates have fallen as a result of U.S. Treasury and Federal Reserve Board actions. The average balance of borrowings increased $10.9 million, or two percent, to $476.4 million during the quarter ended December 31, 2008 from $465.5 million during the same period of fiscal 2008.

For the Six Months Ended December 31, 2008 and 2007. Total interest expense was $22.8 million for the first six months of fiscal 2009 as compared to $28.8 million for the same period of fiscal 2008, a decrease of $6.0 million, or 21 percent. This decrease was primarily attributable to a lower average balance of interest-bearing liabilities and a decrease in the average cost. The average balance of interest-bearing liabilities, principally deposits and borrowings, decreased $25.3 million, or two percent, to $1.44 billion during the first six months of fiscal 2009 from $1.46 billion during the same period of fiscal 2008. The average cost of interest-bearing liabilities was 3.16 percent during the six months ended December 31, 2008, down 75 basis points from 3.91 percent during the same period of fiscal 2008.

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Interest expense on deposits for the six months ended December 31, 2008 was $13.3 million as compared to $18.5 million for the same period of fiscal 2008, a decrease of $5.2 million, or 28 percent. The decrease in interest expense on deposits was primarily attributable to a lower average cost and a lower average balance. The average cost of deposits decreased to 2.76 percent during the six months ended December 31, 2008 from 3.64 percent during the same period of fiscal 2008, a decrease of 88 basis points. The decline in the average balance was primarily in time deposits, the result of the Bank's strategic decision to compete less aggressively for this product. The average balance of deposits decreased $47.9 million, or five percent, to $959.2 million during the six months ended December 31, 2008 from $1.01 billion during the same period of fiscal 2008. The average balance of transaction accounts decreased by $15.4 million, or four percent, to $329.7 million in the six months ended December 31, 2008 from $345.1 million in the six months ended December 31, 2007. The average balance of time deposits decreased by $32.4 million, or five percent, to $629.6 million in the six months ended December 31, 2008 as compared to $662.0 million in the six months ended December 31, 2007. The average balance of transaction account deposits to total deposits in the first six months of fiscal 2009 was unchanged at 34 percent, compared to the same period of fiscal 2008.

Interest expense on borrowings, consisting primarily of FHLB – San Francisco advances, for the six months ended December 31, 2008 decreased $862,000, or eight percent, to $9.5 million from $10.4 million for the same period of fiscal 2008. The decrease in interest expense on borrowings was primarily a result of a lower average cost, partly offset by a higher average balance. The average cost of borrowings decreased to 3.96 percent for the six months ended December 31, 2008 from 4.52 percent in the same period ended December 31, 2007, a decrease of 56 basis points. The decrease in the average cost of borrowings was primarily the result of maturing long-term advances which had a higher average cost than the average cost of new advances. Additionally, short-term advance interest rates have fallen as a result of U.S. Treasury and Federal Reserve Board actions. The average balance of borrowings increased $22.5 million, or five percent, to $477.6 million during the six months ended December 31, 2008 from $455.1 million during the same period of fiscal 2008.

The following table depicts the average balance sheets for the quarters and six months ended December 31, 2008 and 2007, respectively:

Average Balance Sheets
(Dollars in thousands)

| | Quarter Ended December 31, 2008 | | | Quarter Ended December 31, 2007 | | |
|---|---|---|---|---|---|---|
| | Average Balance | Interest | Yield/ Cost | Average Balance | Interest | Yield/ Cost |
| Interest-earning assets: | | | | | | |
| Loans receivable, net (1) | $ 1,325,675 | $ 19,648 | 5.93% | $ 1,398,321 | $ 21,700 | 6.21% |
| Investment securities | 149,314 | 1,804 | 4.83% | 153,816 | 1,902 | 4.95% |
| FHLB – San Francisco stock | 32,769 | (125) | (1.53)% | 30,986 | 432 | 5.58% |
| Interest-earning deposits | 9,595 | 9 | 0.38% | 532 | 5 | 3.76% |
| Total interest-earning assets | 1,517,353 | 21,336 | 5.62% | 1,583,655 | 24,039 | 6.07% |
| Non interest-earning assets | 38,676 | | | 38,159 | | |
| Total assets | $ 1,556,029 | | | $ 1,621,814 | | |
| Interest-bearing liabilities: | | | | | | |
| Checking and money market accounts (2) | $ 184,196 | 302 | 0.65% | $ 195,760 | 499 | 1.01% |
| Savings accounts | 135,785 | 535 | 1.57% | 147,225 | 804 | 2.17% |
| Time deposits | 617,554 | 5,441 | 3.51% | 665,333 | 7,888 | 4.70% |
| Total deposits | 937,535 | 6,278 | 2.66% | 1,008,318 | 9,191 | 3.62% |
| Borrowings | 476,376 | 4,817 | 4.02% | 465,452 | 5,280 | 4.50% |
| Total interest-bearing liabilities | 1,413,911 | 11,095 | 3.12% | 1,473,770 | 14,471 | 3.90% |
| Non interest-bearing liabilities | 20,635 | | | 21,626 | | |
| Total liabilities | 1,434,546 | | | 1,495,396 | | |
| Stockholders’ equity | 121,483 | | | 126,418 | | |
| Total liabilities and stockholders’ equity | $ 1,556,029 | | | $ 1,621,814 | | |

| | | | | |
|---|---|---|---|---|
| Net interest income | $ 10,241 | | $ 9,568 | |
| Interest rate spread (3) | | 2.50% | | 2.17% |
| Net interest margin (4) | | 2.70% | | 2.42% |
| Ratio of average interest-earning assets to average interest-bearing liabilities | | 107.32% | | 107.46% |
| (Loss) return on average assets | | (1.67)% | | 0.26% |
| (Loss) return on average equity | | (21.44)% | | 3.30% |

(1) Includes the receivable from sale of loans, loans held for sale and non-accrual loans, as well as net deferred loan cost amortization of $167 and $210 for the quarters ended December 31, 2008 and 2007, respectively.
(2) Includes the average balance of non interest-bearing checking accounts of $40.1 million and $42.9 million during the quarters ended December 31, 2008 and 2007, respectively.
(3) Represents the difference between the weighted-average yield on all interest-earning assets and the weighted-average rate on all interest-bearing liabilities.
(4) Represents net interest income before provision for loan losses as a percentage of average interest-earning assets.

| | Six Months Ended December 31, 2008 | | | Six Months Ended December 31, 2007 | | |
|---|---|---|---|---|---|---|
| | Average Balance | Interest | Yield/ Cost | Average Balance | Interest | Yield/ Cost |
| Interest-earning assets: | | | | | | |
| Loans receivable, net (1) | $ 1,350,464 | $ 40,306 | 5.97% | $ 1,386,524 | $ 43,214 | 6.23% |
| Investment securities | 152,036 | 3,709 | 4.88% | 151,618 | 3,646 | 4.81% |
| FHLB – San Francisco stock | 32,573 | 324 | 1.99% | 32,951 | 901 | 5.47% |
| Interest-earning deposits | 7,898 | 10 | 0.25% | 639 | 14 | 4.38% |
| Total interest-earning assets | 1,542,971 | 44,349 | 5.75% | 1,571,732 | 47,775 | 6.08% |
| Non interest-earning assets | 37,286 | | | 37,441 | | |
| Total assets | $ 1,580,257 | | | $ 1,609,173 | | |
| Interest-bearing liabilities: | | | | | | |
| Checking and money market accounts (2) | $ 191,250 | 632 | 0.66% | $ 196,851 | 924 | 0.93% |
| Savings accounts | 138,441 | 1,104 | 1.59% | 148,232 | 1,591 | 2.13% |
| Time deposits | 629,558 | 11,568 | 3.65% | 662,049 | 15,946 | 4.78% |
| Total deposits | 959,249 | 13,304 | 2.76% | 1,007,132 | 18,461 | 3.64% |
| Borrowings | 477,642 | 9,511 | 3.96% | 455,075 | 10,373 | 4.52% |
| Total interest-bearing liabilities | 1,436,891 | 22,815 | 3.16% | 1,462,207 | 28,834 | 3.91% |
| Non interest-bearing liabilities | 20,575 | | | 19,555 | | |
| Total liabilities | 1,457,466 | | | 1,481,762 | | |
| Stockholders’ equity | 122,791 | | | 127,411 | | |
| Total liabilities and stockholders’ equity | $ 1,580,257 | | | $ 1,609,173 | | |
| Net interest income | | $ 21,534 | | | $ 18,941 | |
| Interest rate spread (3) | | | 2.59% | | | 2.17% |

| | | |
|---|---|---|
| Net interest margin (4) | 2.79% | 2.41% |
| Ratio of average interest-earning assets to average interest-bearing liabilities | 107.38% | 107.49% |
| (Loss) return on average assets | (0.78)% | 0.21% |
| (Loss) return on average equity | (10.07)% | 2.60% |

(1) Includes the receivable from sale of loans, loans held for sale and non-accrual loans, as well as net deferred loan cost amortization of $288 and $390 for the six months ended December 31, 2008 and 2007, respectively.
(2) Includes the average balance of non interest-bearing checking accounts of $42.6 million and $42.7 million during the six months ended December 31, 2008 and 2007, respectively.
(3) Represents the difference between the weighted-average yield on all interest-earning assets and the weighted-average rate on all interest-bearing liabilities.
(4) Represents net interest income before provision for loan losses as a percentage of average interest-earning assets.

The following table provides the rate/volume variances for the quarters and six months ended December 31, 2008 and 2007, respectively:

Rate/Volume Variance
(In Thousands)

| | Quarter Ended December 31, 2008 Compared To Quarter Ended December 31, 2007 Increase (Decrease) Due to | | | |
|---|---|---|---|---|
| | Rate | Volume | Rate/ Volume | Net |
| Interest-earning assets: | | | | |
| Loans receivable (1) | $ (975) | $ (1,128) | $ 51 | $ (2,052) |
| Investment securities | (43) | (56) | 1 | (98) |
| FHLB – San Francisco stock | (550) | 25 | (32) | (557) |
| Interest-bearing deposits | (4) | 85 | (77) | 4 |
| Total net change in income on interest-earning assets | (1,572) | (1,074) | (57) | (2,703) |
| | | | | |
| Interest-bearing liabilities: | | | | |
| Checking and money market accounts | (178) | (29) | 10 | (197) |
| Savings accounts | (223) | (63) | 17 | (269) |
| Time deposits | (2,024) | (566) | 143 | (2,447) |
| Borrowings | (574) | 124 | (13) | (463) |
| Total net change in expense on interest-bearing liabilities | (2,999) | (534) | 157 | (3,376) |
| Net increase (decrease) in net interest income | $ 1,427 | $ (540) | $ (214) | $ 673 |

(1) Includes the receivable from sale of loans, loans held for sale and non-accrual loans. For purposes of calculating volume, rate and rate/volume variances, non-accrual loans were included in the weighted-average balance outstanding.

| | Six Months Ended December 31, 2008 Compared To Six Months Ended December 31, 2007 Increase (Decrease) Due to | | | |
|---|---|---|---|---|
| | Rate | Volume | Rate/ Volume | Net |
| Interest-earning assets: | | | | |
| Loans receivable (1) | $ (1,832) | $ (1,123) | $ 47 | $ (2,908) |
| Investment securities | 53 | 10 | - | 63 |
| FHLB – San Francisco stock | (574) | (10) | 7 | (577) |
| Interest-bearing deposits | (13) | 159 | (150) | (4) |
| Total net change in income on interest-earning assets | (2,366) | (964) | (96) | (3,426) |
| | | | | |
| Interest-bearing liabilities: | | | | |

| | | | | |
|---|---|---|---|---|
| Checking and money market accounts | (274) | (26) | 8 | (292) |
| Savings accounts | (409) | (105) | 27 | (487) |
| Time deposits | (3,780) | (783) | 185 | (4,378) |
| Borrowings | (1,312) | 514 | (64) | (862) |
| Total net change in expense on interest-bearing liabilities | (5,775) | (400) | 156 | (6,019) |
| Net increase (decrease) in net interest income | $ 3,409 | $ (564) | $ (252) | $ 2,593 |

(1) Includes the receivable from sale of loans, loans held for sale and non-accrual loans. For purposes of calculating volume, rate and rate/volume variances, non-accrual loans were included in the weighted-average balance outstanding.

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Provision for Loan Losses:

For the Quarters Ended December 31, 2008 and 2007. During the second quarter of fiscal 2009, the Corporation recorded a provision for loan losses of $16.5 million, compared to a loan loss provision of $2.1 million during the same period of fiscal 2008. The loan loss provision in the second quarter of fiscal 2009 was primarily attributable to loan classification downgrades ($11.4 million) and an increase in the general loan loss provision for loans held for investment ($5.9 million), partly offset by a decrease in loans held for investment ($805,000). The general loan loss allowance was augmented to reflect the impact on loans held for investment resulting from the deteriorating general economic conditions of the U.S. economy such as the higher unemployment rates, negative gross domestic product indicators and lower retail sales. See related discussion on asset quality on page 32.

For the Six Months Ended December 31, 2008 and 2007. The Corporation recorded a loan loss provision of $22.3 million for the first six months of fiscal 2009, compared to a loan loss provision of $3.7 million during the same period of fiscal 2008. The loan loss provision in the first six months of fiscal 2009 was primarily attributable to loan classification downgrades ($17.5 million) and an increase in the general loan loss provision for loans held for investment ($5.9 million), partly offset by a decrease in loans held for investment ($1.1 million).

At December 31, 2008, the allowance for loan losses was $35.0 million, comprised of $17.0 million of general loan loss reserves and $18.0 million of specific loan loss reserves, in comparison to the allowance for loan losses of $19.9 million at June 30, 2008, comprised of $13.4 million of general loan loss reserves and $6.5 million of specific loan loss reserves. The allowance for loan losses as a percentage of gross loans held for investment was 2.69 percent at December 31, 2008 compared to 1.43 percent at June 30, 2008. Management considers the allowance for loan losses sufficient to absorb potential losses inherent in loans held for investment.

The allowance for loan losses is maintained at a level sufficient to provide for estimated losses based on evaluating known and inherent risks in the loans held for investment and upon management's continuing analysis of the factors underlying the quality of the loans held for investment. These factors include changes in the size and composition of the loans held for investment, actual loan loss experience, current economic conditions, detailed analysis of individual loans for which full collectibility may not be assured, and determination of the realizable value of the collateral securing the loans. Provisions for loan losses are charged against operations on a monthly basis, as necessary, to maintain the allowance at appropriate levels. Management believes that the amount maintained in the allowance will be adequate to absorb losses inherent in the loans held for investment. Although management believes it uses the best information available to make such determinations, there can be no assurance that regulators, in reviewing the Bank's loans held for investment, will not request that the Bank significantly increase its allowance for loan losses. Future adjustments to the allowance for loan losses may be necessary and results of operations could be significantly and adversely affected as a result of economic, operating, regulatory, and other conditions beyond the control of the Bank.

The following table is provided to disclose additional details on the Corporation's allowance for loan losses:

| (Dollars in Thousands) | For the Quarter Ended December 31, 2008 | For the Quarter Ended December 31, 2007 | For the Six Months Ended December 31, 2008 | For the Six Months Ended December 31, 2007 |
|---|---|---|---|---|
| Allowance at beginning of period | $ 22,519 | $ 15,599 | $ 19,898 | $ 14,845 |
| Provision for loan losses | 16,536 | 2,140 | 22,268 | 3,659 |
| Recoveries: | | | | |
| Mortgage loans: | | | | |
| Single-family | 111 | - | 111 | - |
| Construction | 50 | - | 50 | - |
| Consumer loans | - | 1 | 1 | 1 |
| Total recoveries | 161 | 1 | 162 | 1 |
| Charge-offs: | | | | |
| Mortgage loans: | | | | |
| Single-family | (4,223) | (568) | (7,260) | (1,332) |
| Construction | - | - | (73) | - |
| Consumer loans | (2) | (1) | (4) | (2) |
| Other loans | (38) | - | (38) | - |
| Total charge-offs | (4,263) | (569) | (7,375) | (1,334) |
| Net charge-offs | (4,102) | (568) | (7,213) | (1,333) |
| Balance at end of period | $ 34,953 | $ 17,171 | $ 34,953 | $ 17,171 |
| Allowance for loan losses as a percentage of gross loans held for investment | 2.69% | 1.22% | 2.69% | 1.22% |
| Net charge-offs as a percentage of average loans outstanding during the period | 1.24% | 0.16% | 1.07% | 0.19% |
| Allowance for loan losses as a percentage of non-performing loans at the end of the period | 76.24% | 97.44% | 76.24% | 97.44% |

Non-Interest Income:

For the Quarters Ended December 31, 2008 and 2007. Total non-interest income increased $377,000, or 19 percent, to $2.3 million during the quarter ended December 31, 2008 from $1.9 million during the same period of fiscal 2008. The increase was primarily attributable to an increase in the gain on sale of loans and a lower loss on sale and operations of real estate owned acquired in the settlement of loans, partly offset by a decrease in loan servicing and other fees.

Loan servicing and other fees decreased $247,000, or 48 percent, to $266,000 in the second quarter of fiscal 2009 from $513,000 in the same quarter of fiscal 2008. The decrease was primarily attributable to a decrease in other loan fees, primarily related to loan payoffs. Total loan payoffs declined $23.4 million, or 38 percent, to $38.9 million in the second quarter of fiscal 2009 from $62.3 million in the same quarter last year.

The gain on sale of loans increased $460,000, or 49 percent, to $1.4 million for the quarter ended December 31, 2008 from $934,000 in the same quarter of fiscal 2008. The average loan sale margin for

PBM during the second quarter of fiscal 2009 was 0.80 percent, down 29 basis points from 1.09 percent in the same period of fiscal 2008. The gain on sale of loans for the second quarter of fiscal 2009 includes a $1.5 million recourse provision on loans sold that are subject to repurchase, compared to a $38,000 recourse provision recovery in the comparable quarter last year. The gain on sale of loans also includes a favorable fair-value adjustment on derivative financial instruments pursuant to the SFAS No. 133 (a gain of $748,000 versus a gain of $30,000). As of December 31, 2008, the fair value of derivative financial instruments was a gain of $292,000 as compared to a loss of $304,000 at June 30, 2008 and a loss of $29,000 at December 31, 2007. As of December 31, 2008, the total recourse reserve for loans sold that are subject to repurchase was $3.5 million, compared to $2.1 million at June 30, 2008 and $403,000 at December 31, 2007. Total loans sold for the quarter ended December 31, 2008 were $161.1 million, up 57 percent from $102.4 million for the same quarter last year. The mortgage banking environment remains highly volatile as a result of the well-publicized deterioration of the single-family real estate market.

The volume of loans originated for sale increased to $168.7 million in the second quarter of fiscal 2009 as compared to $98.4 million during the same period last year. The increase in loan originations was primarily attributable to better liquidity in the secondary mortgage market particularly in FHA/VA loan products and an increase in activity resulting from lower mortgage interest rates.

The net loss on sale and operations of real estate owned acquired in the settlement of loans was $496,000 in the second quarter of fiscal 2009 compared to a net loss of $704,000 in the same quarter last year. Twenty-two real estate owned properties were sold in the quarter ended December 31, 2008 as compared to six properties in the quarter ended December 31, 2007. See related discussion on asset quality on page 32.

For the Six Months Ended December 31, 2008 and 2007. Total non-interest income increased $1.5 million, or 45 percent, to $4.8 million for the first six months of fiscal 2009 from $3.3 million during the same period of fiscal 2008. The increase was primarily attributable to an increase in the gain on sale of loans, an increase in deposit account fees, the gain on sale of investment securities and a lower loss on sale and operations of real estate owned acquired in the settlement of loans, partly offset by a decrease in loan servicing and other fees.

Loan servicing and other fees decreased $490,000, or 49 percent, to $514,000 in the first six months of fiscal 2009 from $1.0 million in the same period of fiscal 2008. The decrease was primarily attributable to a decrease in other loan fees, primarily related to loan payoffs. Total loan payoffs declined $45.0 million, or 33 percent, to $89.7 million in the first six months of fiscal 2009 from $134.7 million in the same period last year.

The gain on sale of loans increased $1.5 million, or 136 percent, to $2.6 million for the six months ended December 31, 2008 from $1.1 million in the same period of fiscal 2008. The increase was a result of a higher volume of loans sold and a higher average loan sale margin in the first six months of fiscal 2009. Total loans sold for the first six months of fiscal 2009 was $316.4 million, up 59 percent from $199.2 million in the comparable period last year. The volume of loans originated for sale increased by $136.8 million, or 69 percent, to $334.7 million in the first six months of fiscal 2009 as compared to $197.9 million during the same period of fiscal 2008. The average loan sale margin for PBM during the first six months of fiscal 2009 was 0.76 percent, up 16 basis points from 0.60 percent in the same period of fiscal 2008. The increase in the average loan sale margin was primarily attributable to an increase in the fair-value adjustment on derivative financial instruments pursuant to the SFAS No. 133 (a gain of $596,000 versus a loss of $42,000), partly offset by an increase to the recourse reserve for loans sold that are subject to repurchase (a provision of $2.3 million versus a recovery of $81,000).

Deposit account fees increased $92,000, or six percent, to $1.5 million in the first six months of fiscal 2009 from $1.4 million in the same period of fiscal 2008. The increase was primarily attributable to an increase in returned check fees.

The gain on sale of investment securities for the six months ended December 31, 2008 was $356,000, resulting from the sale of equity investments.

The net loss on sale and operations of real estate owned acquired in the settlement of loans was $886,000 for the six months ended December 31, 2008 as compared to a net loss of $1.0 million in the same period ended December 31, 2007. A total of 47 real estate owned properties were sold during the six months ended December 31, 2008 as compared to 10 real estate owned properties in the comparable period in fiscal 2008.

Other non-interest income in the first six months of fiscal 2009 was $696,000 as compared to $827,000 in the same period of fiscal 2008. The decrease was primarily attributable to a decrease in investment service fees.

Non-Interest Expense:

For the Quarters Ended December 31, 2008 and 2007. Total non-interest expense in the quarter ended December 31, 2008 was $7.2 million, a decrease of $81,000 or one percent, as compared to $7.3 million in the same quarter of fiscal 2008. The decrease in non-interest expense was primarily the result of a decrease in premises and occupancy and professional expenses, partly offset by higher deposit insurance premiums and regulatory assessments.

Total premises and occupancy decreased $113,000, or 14 percent, to $718,000 in the second quarter of fiscal 2009 from $831,000 in the same period of fiscal 2008. The decrease was primarily attributable to the cost savings generated from closing five mortgage banking loan production offices in the second quarter of fiscal 2008.

Total professional expenses decreased $142,000, or 30 percent, to $332,000 in the second quarter of fiscal 2009 from $474,000 in the same period of fiscal 2008. The decrease was primarily attributable to lower legal expenses related to the 23 fraudulent, individual construction loans located in Coachella, California.

Total deposit insurance premiums and regulatory assessments increased $173,000, or 150 percent, to $288,000 in the second quarter of fiscal 2009 from $115,000 in the same period of fiscal 2008. The increase was primarily attributable to higher FDIC deposit insurance premiums, which are expected to continue to increase during fiscal 2009.

For the Six Months Ended December 31, 2008 and 2007. Total non-interest expense was $14.6 million for the first six months of fiscal 2009, a decrease of $485,000 or three percent, as compared to $15.1 million in the same period of fiscal 2008. The decrease in non-interest expense was primarily the result of decreases in compensation, premises and occupancy, professional and other operating expenses, partly offset by higher deposit insurance premiums and regulatory assessments.

Total compensation expense in the first six months of fiscal 2009 was $9.2 million, down $496,000 or five percent, from $9.6 million in the same period of fiscal 2008. The decrease in compensation expense was primarily attributable to lower ESOP expenses, partly offset by higher stock-based compensation costs. Total ESOP expenses in the first six months of fiscal 2009 decreased $735,000, or 82 percent, to $164,000 from $899,000 in the same period of fiscal 2008. This decrease was primarily due to fewer shares allocated and a lower average share price.

Total premises and occupancy expense decreased $104,000, or seven percent, to $1.4 million in the first six months of fiscal 2009 from $1.5 million in the same period of fiscal 2008. The decrease was primarily attributable to the cost savings generated from closing five mortgage banking loan production offices in the second quarter of fiscal 2008.

Total professional expenses decreased $101,000, or 13 percent, to $692,000 in the first six months of fiscal 2009 from $793,000 in the same period of fiscal 2008. The decrease was primarily attributable to lower legal expenses related to the 23 fraudulent, individual construction loans located in Coachella, California.

Total deposit insurance premiums and regulatory assessments increased $380,000, or 165 percent, to $610,000 in the first six months of fiscal 2009 from $230,000 in the same period of fiscal 2008. The increase was primarily attributable to higher FDIC deposit insurance premiums, which are expected to continue to increase during fiscal 2009.

Total other operating expenses decreased $127,000, or seven percent, to $1.7 million in the first six months of fiscal 2009 from $1.8 million in the same period of fiscal 2008.

Provision (benefit) for income taxes:

For the Quarters Ended December 31, 2008 and 2007. The income tax benefit was $4.7 million for the quarter ended December 31, 2008 as compared to an income tax provision of $1.0 million during the same period of fiscal 2008. The effective income tax rate for the quarter ended December 31, 2008 decreased to 41.9 percent as compared to 49.2 percent for the same quarter last year. The decrease in the effective income tax rate was primarily the result of a lower percentage of permanent tax differences relative to income or loss before taxes. The Corporation believes that the effective income tax rate applied in the second quarter of fiscal 2009 reflects its current income tax obligations.

For the Six Months Ended December 31, 2008 and 2007. The income tax benefit was $4.4 million for the first six months of fiscal 2009 as compared to an income tax provision of $1.9 million during the same period of fiscal 2008. The effective income tax rate for the six months ended December 31, 2008 decreased to 41.3 percent as compared to 52.9 percent for the same period last year. The decrease in the effective income tax rate was primarily the result of a lower percentage of permanent tax differences relative to income or loss before taxes. The Corporation believes that the effective income tax rate applied in the first six months of fiscal 2009 reflects its current income tax obligations.

Asset Quality

Non-performing loans, consisting solely of non-accrual loans, increased to $45.8 million at December 31, 2008 from $23.2 million at June 30, 2008. The non-accrual loans at December 31, 2008 were primarily comprised of 136 single-family loans held for investment ($38.9 million), three multi-family loans held for investment ($1.1 million), two commercial real estate loans ($1.5 million), 10 construction loans held for investment ($2.3 million, of which nine are associated with the Coachella, California construction loan fraud), six commercial business loans held for investment ($115,000), two land loans held for investment ($1.0 million), and eight single-family loans repurchased from, or unable to sell to investors ($901,000). No interest accruals were made for loans that were past due 90 days or more or if the loans were deemed impaired.

The non-accrual loans as a percentage of net loans held for investment increased to 3.62 percent at December 31, 2008 from 1.70 percent at June 30, 2008. Real estate owned was $11.1 million (61 properties) at December 31, 2008, up 18 percent from $9.4 million (45 properties) at June 30, 2008. Non-performing assets, which includes non-performing loans and real estate owned, as a percentage of total assets increased to 3.67 percent at December 31, 2008 from 1.99 percent at June 30, 2008.

The Bank remains entangled in litigation on the 23 individual construction loans in a single-family construction project located in Coachella, California. The Bank believes that significant misrepresentations were made to secure the Bank's involvement in the project and as a result the Bank is vigorously pursuing legal remedies to protect the Bank's interests. The Bank has delivered demands to the individual borrowers, mortgage loan broker and builder who knowingly misled the Bank on certain key aspects of the loans and the project, which were ignored by the respective parties. Therefore, the Bank has filed lawsuits alleging loan fraud by the 23 individual borrowers, misrepresentation fraud by the mortgage loan broker and misuse of funds fraud by the contractor. The establishment of the specific loan loss reserve is consistent with the improved land value based on an appraisal. Given the number of parties involved or soon to be involved, the complexity of the transaction and probable fraud, this matter may take an extended period of time to resolve. As of December 31, 2008, the Bank foreclosed on 14 of these loans which were converted to real estate owned with a total fair value of $409,000, while the remaining nine loans are classified as substandard with a total fair value of $263,000.

During the second quarter of fiscal 2009, the Bank repurchased $692,000 of loans from investors, fulfilling certain recourse/repurchase covenants in the respective loan sale agreements, and originated $96,000 of loans that could not be sold to investors. This compares to $2.1 million of repurchased loans in the same period of fiscal 2008. For the first six months of fiscal 2009, the Bank repurchased $1.5 million of loans from investors and originated $96,000 of loans that could not be sold to investors. This compares to $3.8 million of repurchased loans and $4.2 million of loans that could not be sold to investors in the same period of fiscal 2008. Many of the repurchases and loans that could not be sold were the result of fraud. The Bank has implemented tighter underwriting standards to reduce this problem.

The Bank reviews loans individually to identify when impairment has occurred. A loan is identified as impaired when it is deemed probable that the borrower will be unable to meet the scheduled principal and interest payments under the terms of the loan agreement. Impairment is based on the present value of expected future cash flows discounted at the loan's effective interest rate, except that as a practical expedient, the Bank may measure impairment based on a loan's observable market price or the fair value of the collateral if the loan is collateral dependent.

The following table describes certain credit risk characteristics of the Corporation's single-family, first trust deed, mortgage loans held for investment as of December 31, 2008, which totaled $755.3 million at December 31, 2008 compared to $802.2 million at June 30, 2008:

| (Dollars in Thousands) | Outstanding Balance (1) | Weighted-Average FICO (2) | Weighted-Average LTV (3) | Weighted-Average Seasoning (4) |
|---|---|---|---|---|
| Interest only | $ 549,246 | 734 | 74% | 2.80 years |
| Stated income (5) | $ 397,336 | 732 | 73% | 3.00 years |
| FICO less than or equal to 660 | $ 20,887 | 641 | 71% | 3.78 years |
| Over 30-year amortization | $ 24,308 | 740 | 68% | 3.30 years |

(1) The outstanding balance presented on this table may overlap more than one category. Of the outstanding balance, $45.6 million of "Interest Only," $35.2 million of "Stated Income," $5.2 million of "FICO Less Than or Equal to 660," and $353,000 of "Over 30-Year Amortization" balances were non-performing.
(2) The FICO score represents the creditworthiness of a borrower based on the borrower's credit history, as reported by an independent third party. A higher FICO score indicates a greater degree of creditworthiness. Bank regulators have issued guidance stating that a FICO score of 660 and below is indicative of a "subprime" borrower.
(3) LTV (loan-to-value) is the ratio calculated by dividing the current loan balance by the original appraised value of the real estate collateral.
(4) Seasoning describes the number of years since the funding date of the loan.
(5) Stated income is defined as borrower provided income which is not subject to verification during the loan origination process.

The following table sets forth information with respect to the Bank's non-performing assets and restructured loans, net of specific loan loss reserves, within the meaning of SFAS No. 15, "Accounting by Debtors and Creditors for Troubled Debt Restructurings," at the dates indicated:

| (Dollars In Thousands) | At December 31, 2008 | At June 30, 2008 |
|---|---|---|
| Loans accounted for on a non-accrual basis: | | |
| Mortgage loans: | | |
| Single-family | $ 39,769 | $ 17,330 |
| Multi-family | 1,112 | - |
| Commercial real estate | 1,520 | 572 |
| Construction | 2,300 | 4,716 |
| Commercial business loans | 115 | - |
| Other loans | 1,032 | 575 |
| Total | 45,848 | 23,193 |
| Accruing loans which are contractually past due 90 days or more | - | - |
| Total of non-performing loans | 45,848 | 23,193 |
| Real estate owned, net | 11,115 | 9,355 |
| Total non-performing assets | $ 56,963 | $ 32,548 |
| Restructured loans (1) | $ 19,598 | $ 10,484 |
| Non-performing loans as a percentage of loans held for investment, net | 3.62% | 1.70% |
| Non-performing loans as a percentage of total assets | 2.96% | 1.42% |
| Non-performing assets as a percentage of total assets | 3.67% | 1.99% |

(1) The amount included in non-performing loans at December 31, 2008 and June 30, 2008 was $11.8 million and $1.4 million, respectively.

All of the loans set forth in the table above have been classified in accordance with OTS regulations. Total classified loans (including loans designated as special mention) were $61.7 million at December 31, 2008, an increase of $2.5 million or four percent, from $59.2 million at June 30, 2008. The classified loans at December 31, 2008 consist of 39 loans in the special mention category (25 single-family loans of $9.1 million, five multi-family loans of $2.9 million, four commercial real estate loans of $1.4 million, four commercial business loans of $548,000 and one construction loan of $400,000) and 176 loans in the substandard category (151 single-family loans of $41.0 million, 10 construction loans of $2.3 million, two commercial real estate loans of $1.5 million, three land loans of $1.3 million, three multi-family loans of $1.1 million and seven commercial business loans of $116,000).

The classified loans at June 30, 2008 consisted of 46 loans in the special mention category (33 single-family loans of $11.8 million, two construction loans of $8.1 million, six multi-family loans of $8.0 million, two commercial real estate loans of $1.4 million, one commercial business loans of $100,000, one land loan of $28,000 and one consumer loan of $20,000) and 97 loans in the substandard category (79 single-family loans of $23.6 million, 12 construction loans of $4.7 million, two land loans of $575,000, one commercial real estate loan of $572,000, one multi-family loan of $367,000 and two fully reserved commercial business loans).

As of December 31, 2008, real estate owned was comprised of 61 properties (11 from loan repurchases and loans which could not be sold and 50 from loans held for investment), primarily located in Southern California, with a net fair value of $11.1 million. A new appraisal was obtained on each of the properties and fair value was calculated by using the lower of appraised value or the listing price of the property, net of selling costs. Any initial loss is recorded as a charge to the allowance for loan losses before being transferred to real estate owned. Subsequently, if there is further deterioration in real estate values, specific real estate loss reserves are established and charged to the statement of operations. In addition, the Corporation reflects costs to carry real estate owned as real estate operating expenses when incurred. As of June 30, 2008, real estate owned was comprised of 45 properties (nine from loan repurchases and 36 from loans held for investment), primarily located in Southern California, with a net fair value of $9.4 million. For the quarter ended December 31, 2008, thirty-five real estate owned properties were acquired in the settlement of loans, while 22 real estate owned properties were sold for a net gain of $572,000. For the six months ended December 31, 2008, sixty-three real estate owned properties were acquired in the settlement of loans, while 47 real estate owned properties were sold for a net gain of $439,000.

For the quarter ended December 31, 2008, 20 loans for $7.4 million were modified from their original terms, were re-underwritten and were identified in the Corporation's asset quality reports as restructured loans. For the six months ended December 31, 2008, 30 loans for $14.1 million were modified from their original terms, were re-underwritten and were identified in the Corporation's asset quality reports as restructured loans. As of December 31, 2008, the outstanding balance of modified loans was $19.6 million: 22 are classified as pass and remain on accrual status ($7.6 million); one is classified as substandard and remains on accrual status ($240,000); 34 are classified as substandard on non-accrual status ($11.8 million); and one is classified as loss on non-accrual status ($120,000). To qualify for restructuring, a borrower must provide evidence of their creditworthiness such as, current financial statements, their most recent income tax returns, current paystubs, current W-2s, and most recent bank statements, among other documents, which are then verified by the Bank. The Bank re-underwrites the loan with the borrower's updated financial information, new credit report, current loan balance, new interest rate, remaining loan term, updated property value and modified payment schedule, among other considerations, to determine if the borrower qualifies.

Loan Volume Activities

The following table is provided to disclose details related to the volume of loans originated, purchased and sold (in thousands):

| | For the Quarter Ended December 31, | | For the Six Months Ended December 31, | |
|---|---|---|---|---|
| | 2008 | 2007 | 2008 | 2007 |
| Loans originated for sale: | | | | |
| Retail originations | $ 48,269 | $ 30,075 | $ 99,827 | $ 64,634 |
| Wholesale originations | 120,389 | 68,324 | 234,833 | 133,278 |
| Total loans originated for sale (1) | 168,658 | 98,399 | 334,660 | 197,912 |
| | | | | |
| Loans sold: | | | | |
| Servicing released | (161,104) | (102,009) | (316,162) | (196,648) |
| Servicing retained | - | (395) | (193) | (2,534) |
| Total loans sold (2) | (161,104) | (102,404) | (316,355) | (199,182) |
| | | | | |
| Loans originated for investment: | | | | |
| Mortgage loans: | | | | |
| Single-family | - | 32,738 | 7,476 | 63,033 |
| Multi-family | 3,300 | 18,914 | 4,500 | 26,428 |
| Commercial real estate | - | 9,252 | 2,073 | 10,758 |
| Construction | - | 1,984 | 265 | 11,662 |
| Commercial business loans | 500 | 196 | 580 | 361 |
| Consumer loans | - | 212 | 531 | 212 |
| Other loans | - | 1,680 | 1,740 | 1,680 |
| Total loans originated for investment (3) | 3,800 | 64,976 | 17,165 | 114,134 |
| | | | | |
| Loans purchased for investment: | | | | |
| Mortgage loans: | | | | |
| Multi-family | - | 25,921 | - | 68,130 |
| Commercial real estate | - | 1,996 | - | 1,996 |
| Construction | - | 400 | - | 400 |
| Other loans | - | 1,000 | - | 1,000 |
| Total loans purchased for investment | - | 29,317 | - | 71,526 |
| | | | | |
| Mortgage loan principal payments | (38,877) | (62,341) | (89,731) | (134,682) |
| Real estate acquired in settlement of loans | (15,678) | (4,711) | (26,151) | (8,393) |
| (Decrease) increase in other items, net (4) | (6,028) | 1,334 | (4,335) | 2,056 |
| Net (decrease) increase in loans held for investment and loans held for sale | $ (49,229) | $ 24,570 | $ (84,747) | $ 43,371 |

(1)

Primarily comprised of PBM loans originated for sale, totaling \$168.7 million, \$98.4 million, \$334.7 million and \$195.5 million for the quarters and six months ended December 31, 2008 and 2007, respectively.

(2) Primarily comprised of PBM loans sold, totaling \$161.1 million, \$101.6 million, \$316.4 million and \$196.7 million for the quarters and six months ended December 31, 2008 and 2007, respectively.

(3) Primarily comprised of PBM loans originated for investment, totaling \$0, \$32.8 million, \$8.0 million and \$66.4 million for the quarters and six months ended December 31, 2008 and 2007, respectively.

(4) Includes net changes in undisbursed loan funds, deferred loan fees or costs, escrow accounts and allowance for loan losses.

Liquidity and Capital Resources

The Corporation's primary sources of funds are deposits, proceeds from the sale of loans originated for sale, proceeds from principal and interest payments on loans, proceeds from the maturity of investment securities and FHLB – San Francisco advances. While maturities and scheduled amortization of loans and investment securities are a relatively predictable source of funds, deposit flows, mortgage prepayments and loan sales are greatly influenced by general interest rates, economic conditions and competition.

The primary investing activity of the Bank is the origination and purchase of loans held for investment. During the first six months of fiscal 2009 and 2008, the Bank originated loans in the amounts of $351.8 million and $312.0 million, respectively. In addition, the Bank did not purchase any loans from other financial institution in the first six months of fiscal 2009 compared to purchases of $71.5 million in the first six months of fiscal 2008. The total loans sold in the first six months of fiscal 2009 and 2008 were $316.4 million and $199.2 million, respectively. At December 31, 2008, the Bank had loan origination commitments totaling $46.2 million and undisbursed loans in process and lines of credit totaling $15.5 million. The Bank anticipates that it will have sufficient funds available to meet its current loan commitments.

The Bank's primary financing activity is gathering deposits. During the first six months of fiscal 2009, the net decrease in deposits was $77.6 million in comparison to a net increase in deposits of $4.3 million during the same period in fiscal 2008. On December 31, 2008, time deposits that are scheduled to mature in one year or less were $550.1 million. Historically, the Bank has been able to retain a significant amount of its time deposits as they mature by adjusting deposit rates to the current interest rate environment.

The Bank must maintain an adequate level of liquidity to ensure the availability of sufficient funds to support loan growth and deposit withdrawals, to satisfy financial commitments and to take advantage of investment opportunities. The Bank generally maintains sufficient cash and cash equivalents to meet short-term liquidity needs. At December 31, 2008, total cash and cash equivalents were $17.5 million, or 1.13 percent of total assets. Depending on market conditions and the pricing of deposit products and FHLB – San Francisco advances, the Bank may continue to rely on FHLB – San Francisco advances for part of its liquidity needs. As of December 31, 2008, the financing availability at FHLB – San Francisco is limited to 45 percent of total assets and the remaining borrowing capacity was $259.4 million.

On December 3, 2008, the Bank elected to participate in the FDIC Temporary Liquidity Guarantee Program ("TLGP"), which consists of the Transaction Account Guarantee Program ("TAGP") and Debt Guarantee Program ("DGP"). Through the TAGP, the FDIC will provide unlimited deposit insurance coverage for all noninterest-bearing transaction accounts through December 31, 2009. This includes traditional non-interest bearing checking accounts, certain types of attorney trust accounts and NOW accounts as long as the interest rate does not exceed 0.50 percent. The program is designed to enhance depositor confidence in the safety of the United States banking system. Through the DGP, the Bank has an option to issue senior unsecured debt (fully guaranteed by the FDIC) on or before June 30, 2009 with a maturity of June 30, 2012 or sooner. If the Bank chooses to issue debt under the DGP program it will be limited to two percent of its liabilities as of September 30, 2008, or approximately $29.4 million.

Although the OTS eliminated the minimum liquidity requirement for savings institutions in April 2002, the regulation still requires thrifts to maintain adequate liquidity to assure safe and sound operations. The Bank's average liquidity ratio (defined as the ratio of average qualifying liquid assets to average deposits and borrowings) for the quarter ended December 31, 2008 increased to 7.2 percent from 4.6 percent during the quarter ended June 30, 2008. During the first six months of fiscal 2009, the United States ("the U.S.") and international banking systems were under a considerable strain as a result of large financial losses experienced by many financial institutions worldwide. As a result, the U.S. government has taken many actions designed to alleviate liquidity concerns in the U.S. banking system. Those well publicized actions seem to have stabilized the U.S. banking system. The Bank did not experience any specific liquidity problems during the course of the second quarter of fiscal 2009 although it is probable that interest rates paid for deposits and borrowings were elevated as a result of the market turmoil.

The Bank is required to maintain specific amounts of capital pursuant to OTS requirements. Under the OTS prompt corrective action provisions, a minimum ratio of 1.5 percent for Tangible Capital is required to be deemed other than “critically undercapitalized,” while a minimum of 5.0 percent for Core Capital, 10.0 percent for Total Risk-Based Capital and 6.0 percent for Tier 1 Risk-Based Capital is required to be deemed “well capitalized.” As of December 31, 2008, the Bank exceeded all regulatory capital requirements. The Bank’s actual and required capital amounts and ratios as of December 31, 2008 are as follows (dollars in thousands):

| | Amount | Percent |
|---|---|---|
| Tangible capital | $ 112,412 | 7.25% |
| Requirement | 31,007 | 2.00 |
| Excess over requirement | $ 81,405 | 5.25% |
| Core capital | $ 112,412 | 7.25% |
| Requirement to be “Well Capitalized” | 77,518 | 5.00 |
| Excess over requirement | $ 34,894 | 2.25% |
| Total risk-based capital | $ 121,254 | 12.88% |
| Requirement to be “Well Capitalized” | 94,123 | 10.00 |
| Excess over requirement | $ 27,131 | 2.88% |
| Tier 1 risk-based capital | $ 109,424 | 11.63% |
| Requirement to be “Well Capitalized” | 56,474 | 6.00 |
| Excess over requirement | $ 52,950 | 5.63% |

Commitments and Derivative Financial Instruments

The Corporation is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit, in the form of originating loans or providing funds under existing lines of credit, and mandatory loan sale agreements to third parties. These instruments involve, to varying degrees, elements of credit and interest-rate risk in excess of the amount recognized in the accompanying condensed consolidated statements of financial condition. The Corporation’s exposure to credit loss, in the event of non-performance by the counterparty to these financial instruments, is represented by the contractual amount of these instruments. The Corporation uses the same credit policies in entering into financial instruments with off-balance sheet risk as it does for on-balance sheet instruments. For a discussion on commitments and derivative financial instruments, see Note 5 of the Notes to Unaudited Interim Consolidated Financial Statements on page 11.

Stockholders’ Equity

The ability of the Corporation to pay dividends to stockholders depends primarily on the ability of the Bank to pay dividends to the Corporation. The Bank may not declare or pay a cash dividend if the effect thereof would cause its net worth to be reduced below the regulatory capital requirements imposed by federal and state regulation. The Corporation paid $620,000 of cash dividends to its shareholders in the first six months of fiscal 2009.

In June 2008, the Corporation’s Board of Directors authorized a stock repurchase program; however, in order to preserve capital during this difficult banking environment, the Corporation has not repurchased any of its stock under this program during the six months ended December 31, 2008. As of December 31, 2008, all of the 310,385 authorized shares from the June 2008 stock repurchase program are available for future repurchase.

Incentive Plans

As of December 31, 2008, the Corporation had three share-based compensation plans, which are described below. These plans include the 2006 Equity Incentive Plan, 2003 Stock Option Plan and 1996 Stock Option Plan. The compensation cost that has been charged against income for these plans was $299,000 and $199,000 for the quarters ended December 31, 2008 and 2007, respectively, and there was no tax benefit from these plans during either quarter. For the six months ended December 31, 2008 and 2007, the compensation cost for these plans was $558,000 and $385,000, respectively, and the tax benefit from these plans was $0 and $6,000, respectively.

Equity Incentive Plan. The Corporation established and the shareholders approved the 2006 Equity Incentive Plan ("2006 Plan") for directors, advisory directors, directors emeriti, officers and employees of the Corporation and its subsidiary. The 2006 Plan authorizes 365,000 stock options and 185,000 shares of restricted stock. The 2006 Plan also provides that no person may be granted more than 73,000 shares of stock options or 27,750 shares of restricted stock in any one year.

Equity Incentive Plan - Stock Options. Under the 2006 Plan, options may not be granted at a price less than the fair market value at the date of the grant. Options typically vest over a five-year or shorter period as long as the director, advisory director, director emeriti, officer or employee remains in service to the Corporation. The options are exercisable after vesting for up to the remaining term of the original grant. The maximum term of the options granted is 10 years.

The fair value of each option grant is estimated on the date of the grant using the Black-Scholes option valuation model with the assumptions noted in the following table. The expected volatility is based on implied volatility from historical common stock closing prices for the last 84 months. The expected dividend yield is based on the most recent quarterly dividend on an annualized basis. The expected term is based on the historical experience of all fully vested stock option grants and is reviewed annually. The risk-free interest rate is based on the U.S. Treasury note rate with a term similar to the underlying stock option on the particular grant date.

| | Quarter Ended December 31, 2008 | Quarter Ended December 31, 2007 | Six Months Ended December 31, 2008 | Six Months Ended December 31, 2007 |
|---|---|---|---|---|
| Expected volatility | - | - | 35% | 22% |
| Weighted-average volatility | - | - | 35% | 22% |
| Expected dividend yield | - | - | 2.8% | 3.6% |
| Expected term (in years) | - | - | 7.0 | 7.4 |
| Risk-free interest rate | - | - | 3.5% | 4.8% |

There was no stock option activity in the second quarter of fiscal 2009. This compares to a total of 13,500 options forfeited and no other activity in the second quarter of fiscal 2008. For the first six months of fiscal 2009, a total of 182,000 options were granted, while no options were exercised or forfeited. This compares to a total of 12,000 options forfeited, while no options were granted or exercised during the first six months of fiscal 2008. As of December 31, 2008 and 2007, there were 7,700 options and 189,700 options available for future grants under the 2006 Plan, respectively.

The following table summarizes the stock option activity in the 2006 Plan for the quarter and six months ended December 31, 2008.

| Options | Shares | Weighted-Average Exercise Price | Weighted-Average Remaining Contractual Term (Years) | Aggregate Intrinsic Value ($000) |
|---|---|---|---|---|
| Outstanding at October 1, 2008 | 357,300 | $ 17.47 | | |
| Granted | - | - | | |
| Exercised | - | - | | |
| Forfeited | - | - | | |
| Outstanding at December 31, 2008 | 357,300 | $ 17.47 | 5.30 | $ - |
| Vested and expected to vest at December 31, 2008 | 292,852 | $ 17.73 | 5.37 | $ - |
| Exercisable at December 31, 2008 | 35,060 | $ 28.31 | 8.11 | $ - |

| Options | Shares | Weighted-Average Exercise Price | Weighted-Average Remaining Contractual Term (Years) | Aggregate Intrinsic Value ($000) |
|---|---|---|---|---|
| Outstanding at July 1, 2008 | 175,300 | $ 28.31 | | |
| Granted | 182,000 | $ 7.03 | | |
| Exercised | - | - | | |
| Forfeited | - | - | | |
| Outstanding at December 31, 2008 | 357,300 | $ 17.47 | 5.30 | $ - |
| Vested and expected to vest at December 31, 2008 | 292,852 | $ 17.73 | 5.37 | $ - |
| Exercisable at December 31, 2008 | 35,060 | $ 28.31 | 8.11 | $ - |

As of December 31, 2008 and 2007, there was $873,000 and $747,000 of unrecognized compensation expense, respectively, related to unvested share-based compensation arrangements granted under the stock options in the 2006 Plan. The expense is expected to be recognized over a weighted-average period of 2.8 years and 4.1 years, respectively. The forfeiture rate during the first six months of fiscal 2009 was 20 percent and was calculated by using the historical forfeiture experience of all fully vested stock option grants and is reviewed annually.

Equity Incentive Plan – Restricted Stock. The Corporation will use 185,000 shares of its treasury stock to fund the 2006 Plan. Awarded shares typically vest over a five-year or shorter period as long as the director, advisory director, director emeriti, officer or employee remains in service to the Corporation. Once vested, a recipient of restricted stock will have all rights of a shareholder, including the power to vote and the right to receive dividends. The Corporation recognizes compensation expense for the restricted stock awards based on the fair value of the shares at the award date.

There was no restricted stock activity in the second quarter of fiscal 2009 and 2008. For the first six months of fiscal 2009, a total of 100,300 shares of restricted stock were awarded, while 800 shares were vested and distributed, and no restricted stock was forfeited. This compares to a total of 4,000 shares of restricted stock awarded, 6,000 shares forfeited, and no restricted stock vested or distributed during the first six months of fiscal 2008. As of December 31, 2008 and 2007, there were 23,950 shares and 124,250 shares of restricted stock available for future awards, respectively.

The following table summarizes the unvested restricted stock activity in the quarter and six months ended December 31, 2008.

| Unvested Shares | Shares | Weighted-Average Award Date Fair Value |
|---|---|---|
| Unvested at October 1, 2008 | 148,900 | $ 14.84 |
| Granted | - | - |
| Vested | - | - |
| Forfeited | - | - |
| Unvested at December 31, 2008 | 148,900 | $ 14.84 |
| Expected to vest at December 31, 2008 | 119,120 | $ 14.84 |

| Unvested Shares | Shares | Weighted-Average Award Date Fair Value |
|---|---|---|
| Unvested at July 1, 2008 | 49,400 | $ 25.81 |
| Granted | 100,300 | $ 6.46 |
| Vested | (800) | $ 18.09 |
| Forfeited | - | - |
| Unvested at December 31, 2008 | 148,900 | $ 14.84 |
| Expected to vest at December 31, 2008 | 119,120 | $ 14.84 |

As of December 31, 2008 and 2007, there was $1.8 million and $1.4 million of unrecognized compensation expense, respectively, related to unvested share-based compensation arrangements awarded under the restricted stock in the 2006 Plan, and reported as a reduction to stockholders' equity. This expense is expected to be recognized over a weighted-average period of 3.0 years and 4.1 years, respectively. Similar to options, a forfeiture rate of 20 percent is used for the restricted stock compensation expense calculations.

Stock Option Plans. The Corporation established the 1996 Stock Option Plan and the 2003 Stock Option Plan (collectively, the "Stock Option Plans") for key employees and eligible directors under which options to acquire up to 1.15 million shares and 352,500 shares of common stock, respectively, may be granted. Under the Stock Option Plans, options may not be granted at a price less than the fair market value at the date of the grant. Options vest over a five-year period on a pro-rata basis as long as the employee or director remains in service to the Corporation. The options are exercisable after vesting for up to the remaining term of the original grant. The maximum term of the options granted is 10 years.

On April 28, 2005, the Board of Directors accelerated the vesting of 136,950 unvested stock options, which were previously granted to directors, officers and key employees who had three or more continuous years of service with the Corporation or an affiliate of the Corporation. The Board believed that it was in the best interest of the shareholders to accelerate the vesting of these options which were granted prior to January 1, 2004, since it had a positive impact on the future earnings of the Corporation. This action was taken as a result of SFAS No. 123R which the Corporation adopted on July 1, 2005.

As a result of accelerating the vesting of these options, the Corporation recorded a $320,000 charge to compensation expense during the quarter ended June 30, 2005. This charge represents a new measurement of compensation cost for these options as of the modification date. The modification introduced the potential for an effective renewal of the awards as some of these options may have been forfeited by the holders. This charge requires quarterly adjustment in future periods for actual forfeiture experience. A final recovery of $19,000 was realized in the first quarter of fiscal 2009; and since inception, all of the original costs have been recovered. The Corporation estimates that the compensation expense related to these options that would have been recognized over their remaining vesting period pursuant to the transition provisions of SFAS No. 123R is $1.7 million.

The fair value of each option grant is estimated on the date of the grant using the Black-Scholes option valuation model with the assumptions noted in the following table. The expected volatility is based on implied volatility from historical common stock closing prices for the last 84 months. The expected dividend yield is based on the most recent quarterly dividend on an annualized basis. The expected term is based on the historical experience of all fully vested stock option grants and is reviewed annually. The risk-free interest rate is based on the U.S. Treasury note rate with a term similar to the underlying stock option on the particular grant date.

| | Quarter Ended December 31, 2008 | Quarter Ended December 31, 2007 | Six Months Ended December 31, 2008 | Six Months Ended December 31, 2007 |
|---|---|---|---|---|
| Expected volatility | - | - | - | 22% |
| Weighted-average volatility | - | - | - | 22% |
| Expected dividend yield | - | - | - | 3.6% |
| Expected term (in years) | - | - | - | 7.4 |
| Risk-free interest rate | - | - | - | 4.8% |

There was no activity in the second quarter of fiscal 2009 and 2008. For the first six months of fiscal 2009, there was no stock option activity. This compares to a total of 50,000 options that were granted, 7,500 options that were exercised, and 48,700 options forfeited in the first six months of fiscal 2008. As of December 31, 2008 and 2007, the number of options available for future grants under the Stock Option Plans were 14,900 and 14,900 options, respectively.

The following is a summary of the activity in the Stock Option Plans for the quarter and six months ended December 31, 2008.

| Options | Shares | Weighted-Average Exercise Price | Weighted-Average Remaining Contractual Term (Years) | Aggregate Intrinsic Value ($000) |
|---|---|---|---|---|
| Outstanding at October 1, 2008 | 550,400 | $ 20.52 | | |
| Granted | - | - | | |
| Exercised | - | - | | |
| Forfeited | - | - | | |
| Outstanding at December 31, 2008 | 550,400 | $ 20.52 | 5.10 | $ - |
| Vested and expected to vest at December 31, 2008 | 524,960 | $ 20.30 | 5.01 | $ - |
| Exercisable at December 31, 2008 | | | | |