MONTEREY BAY BANCORP INC
Form 10-K
March 27, 2002

SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549
FORM 10-K

Annual Report Pursuant to Section 13 or 15 (d) of the
Securities Exchange Act of 1934
For the fiscal year ended December 31, 2001

Commission File Number: 0-24802

MONTEREY BAY BANCORP, INC.
(Exact Name Of Registrant As Specified In Its Charter)

DELAWARE	77-0381362
(State Or Other Jurisdiction Of Incorporation Or Organization)	(I.R.S. Employer Identification Number)

567 Auto Center Drive, Watsonville, California 95076
(Address Of Principal Executive Offices)(Zip Code)

(831) 768 - 4800
(Registrant's Telephone Number, Including Area Code)

Securities registered pursuant to Section 12(b) of the Act: None
Securities registered pursuant to Section 12(g) of the Act:
Common Stock, $0.01 par value per share
(Title Of Class)

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

The aggregate market value of the Common Stock held by "non-affiliates" of the registrant, based upon the closing sale price of its Common Stock on March 4, 2002, as quoted on the Nasdaq National Market System, was approximately $32,562,000. Shares of common stock held by each officer, director, and holder of 5% or more of the outstanding Common Stock have been excluded in that such persons or entities may be deemed to be affiliates. Such determination of affiliate status is not necessarily a conclusive determination for other purposes.

The registrant had 3,483,718 shares of Common Stock outstanding as of March 20, 2002.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the definitive Proxy Statement for the 2002 Annual Meeting of Stockholders to be filed within 120 days of the fiscal year ended December 31, 2001 are incorporated by reference into Part III of this Form 10-K.

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PART I

Discussions of certain matters in this Annual Report on Form 10-K may constitute forward-looking statements within the meaning of the Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities and Exchange Act of 1934, as amended (the "Exchange Act"), and as such, may involve risks and uncertainties. Forward-looking statements, which are based on certain assumptions and describe future plans, strategies, and expectations, are generally identifiable by the use of words or phrases such as "believe", "expect", "intend", "anticipate", "estimate", "project", "forecast", "may increase", "may fluctuate", "may improve" and similar expressions or future or conditional verbs such as "will", "should", "would", and "could". These forward-looking statements relate to, among other things, expectations of the business environment in which Monterey Bay Bancorp, Inc. operates, opportunities and expectations regarding technologies, anticipated performance or contributions from new and existing employees, projections of future performance, potential future credit experience, possible changes in laws and regulations, potential risks and benefits arising from the implementation of the Company's strategic and tactical plans, perceived opportunities in the market, potential actions of significant stockholders and investment banking firms, the potential impact of past and possible future terrorist actions upon consumer confidence, income, and spending, and statements regarding the Company's mission and vision. The Company's actual results, performance, and achievements may differ materially from the results, performance, and achievements expressed or implied in such forward-looking statements due to a wide range of factors. For a discussion of some of the factors that might cause such a difference, including, but not limited to, changes in interest rates, general economic conditions, technology, legislative and regulatory changes, monetary and fiscal policies of the US Government, US Treasury, and Federal Reserve, real estate valuations, and competition in the financial services industry, see "Item 1. Business - Risk Factors That May Affect Future Results." These factors should be considered in evaluating the forward-looking statements, and undue reliance should not be placed on such statements. The Company does not undertake, and specifically disclaims any obligation, to update any forward-looking statements to reflect occurrences or unanticipated events or circumstances after the date of such statements.

Item 1. Business.

General

Monterey Bay Bancorp, Inc. (referred to herein on an unconsolidated basis as "MBBC" and on a consolidated basis as the "Company") is a unitary savings and loan holding company incorporated in 1994 under the laws of the state of Delaware. MBBC currently maintains a single subsidiary company, Monterey Bay Bank (the "Bank"), formerly Watsonville Federal Savings and Loan Association. MBBC was organized as the holding company for the Bank in connection with the Bank's conversion from the mutual to stock form of ownership in 1995.

At December 31, 2001, the Company had $537.4 million in total assets, $466.6 million in net loans receivable, and $432.3 million in total deposits. The Company is subject to regulation by the Office of Thrift Supervision ("OTS"), the Federal Deposit Insurance Corporation ("FDIC"), and the Securities and Exchange Commission ("SEC"). The principal executive offices of the Company and the Bank are located at 567 Auto Center Drive, Watsonville, California, 95076, telephone number (831) 768 - 4800, facsimile number (831) 722 - 6794. The Company may also be contacted via electronic mail at: INFO@MONTEREYBAYBANK.COM. Information concerning the Company may be accessed at the following Internet site: WWW.MONTEREYBAYBANK.COM. This Internet site is not a part of this Annual report on Form 10-K. The Bank is a member of the Federal Home Loan Bank of San Francisco ("FHLB") and its deposits are insured by the FDIC to the maximum extent permitted by law.

The Company conducts business from eight branch offices, two stand alone ATM sites, and its administrative headquarters buildings. In addition, the Company supports its customers through Internet Banking, 24 hour bilingual telephone banking, courier service, mail, and ATM access through 11 owned ATM's and an array of ATM networks including STAR, CIRRUS, and PLUS.

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Through its network of banking offices, the Bank emphasizes personalized service focused upon three primary markets: households, professionals, and businesses. The Bank offers a wide complement of lending products, including:

- a broad array of residential mortgage products, both fixed and adjustable rate
- consumer loans, including home equity lines of credit and overdraft lines of credit
- specialized financing programs to support community development
- mortgages for multifamily real estate
- commercial and industrial real estate loans
- construction lending for single family residences, apartment buildings, and commercial real estate
- commercial loans to businesses, including both revolving lines of credit and term loans

The Bank also provides an extensive selection of deposit instruments. These include:

- multiple checking products for both personal and business accounts, with imaged statements available
- various savings accounts
- tiered money market accounts offering a variety of access methods
- tax qualified deposit accounts (e.g. IRA's)
- a broad array of certificate of deposit products

Through its wholly-owned subsidiary, Portola Investment Corporation ("Portola"), the Bank provides, on an agency basis, life insurance (term, whole life, and universal life insurance), fire insurance, and a wide selection of non-FDIC insured investment products including:

- fixed annuities
- variable annuities
- an extensive inventory of mutual funds
- individual fixed income and equity securities

Please see "Subsidiary Activities" for additional information regarding business activities by Portola.

The Bank also supports its customers by functioning as a federal tax depository, selling and purchasing foreign banknotes, issuing debit cards, providing domestic and international collection services, and supplying various forms of electronic funds transfer.

The Company participates in the wholesale capital markets through the management of its security portfolio and its use of various forms of wholesale funding. The Company's security portfolio contains a variety of instruments, including collateralized mortgage obligations ("CMO's"). The Company also participates in the secondary market for loans as both a purchaser and a seller of various types of loan products.

The Company's revenues are primarily derived from interest on its loan and mortgage backed securities portfolios, interest and dividends on its investment securities, and fee income associated with the provision of various customer services. Interest paid on deposits and borrowings constitutes the Company's largest type of expense. The Company's primary sources of funds are deposits, principal and interest payments on its asset portfolios, and various sources of wholesale borrowings including FHLB advances, federal funds purchased, and securities sold under agreements to repurchase. The Company's most significant operating expenditures are its staffing expenses and the costs associated with maintaining its branch network.

Additional information concerning the Company's business is presented under "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations."

Company Strategy

During the past several years, the Company has adopted and has been implementing a business strategy of evolving away from its traditional savings and loan roots toward a community commercial banking orientation. This business strategy was selected:

- so that the Company might better and more completely address the financial needs of the communities it serves

- because of the constrained financial returns associated with the traditional thrift business of funding residential mortgage loans with certificates of deposit for entities the size of the Bank

- due to the increasing commoditization of residential mortgages, spurred by new technologies and revised business practices supported by Federal Agencies such as the Federal National Mortgage Association ("FNMA" or "Fannie Mae") and the Federal Home Loan Mortgage Corporation ("FHLMC" or "Freddie Mac")

- to augment stockholder value, as the Company believes that successful community commercial banks generally receive a more favorable valuation in the capital markets than traditional savings and loans

- to develop more robust and recurring sources of income

The Company's community commercial banking strategy incorporates:

- a relationship based approach to customer service, marketing, and pricing

- a focus on understanding the profile and objectives of the Company's customers as a means to provide enhanced service while also supporting credit quality

- a high level of community involvement and visibility by the Company, its directors, and its employees

- a balance sheet profile presenting loan and deposit portfolios diversified among multiple products

- a ratio of net loans to total assets of between 85.0% and 90.0%

o income property, construction, and business loans representing a greater percentage of total loans than has been maintained in the past, with a reduced concentration in residential mortgages

o a deposit mix with a greater percentage of transaction accounts than has been maintained in the past, with a lower concentration of certificates of deposit

o increasing fee income to a greater portion of total revenue than historically generated

o utilizing new technologies to better meet the financial needs of individuals, families, professionals, and businesses

As discussed below and throughout this Annual Report, the Company has achieved progress in these regards over the past several years, including some particular accomplishments in 2001.

In general, the Company's accomplishments in 2001 can be grouped into three categories:

1. The successful resolution of certain historical issues that have hindered the Company's progress with the strategic plan, including:

   A. the conclusion of a lengthy arbitration proceeding with the former President and Chief Operating Officer regarding payments due to him under his employment agreements

   B. the significant reduction, without loss, in the outstanding balance of a pool of loans acquired in 1998 that presented a credit profile less favorable than the Company's normal underwriting criteria (see "Special Residential Loan Pool" and Note 14 to the Consolidated Financial Statements)

   C. the elimination in early 2002 of institution specific regulatory capital requirements for the Bank imposed by the OTS in early 2000 in response to the Special Residential Loan Pool

   D. the collection in full of several loans with significant principal balances that were delinquent at December 31, 2000

2. The establishment of the human resource and technology foundations necessary to successfully implement the Company's strategy, including:

   A. a new core data processing system

   B. the hiring of additional commercial business relationship officers

   C. the recruitment of veteran bankers to key positions at the Company, including Chief Administrative Officer, Director of Information Technology, Director of Community Relations, and Controller

   D. the introduction of new and the redesign of existing financial products and services

3. The advancement of the Company along its strategic plan, including:

   A. improved financial results, including record levels of assets, loans, deposits, and stockholders' equity at December 31, 2001, combined with record annual net income for 2001

   B. increased commercial business loans and the development of an expanded commercial lending pipeline

   C. implementation of various strategies designed to increase stockholder value

While the market price of the Company's common stock appreciated favorably in 2001, in part due to the above accomplishments, the Company's Board of Directors and Management acknowledge that the Company has yet to deliver the range of return on stockholders' equity produced by higher performing peer financial institutions. Building on the achievements of 2001 to improve the Company's return on stockholders' equity is a key objective for 2002.

Additional information regarding the Company's strategic plan and its accomplishments in relation thereto is presented in the following paragraphs and throughout this Annual Report.

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Consistent with the strategic plan, the Company has endeavored to reduce the level of relatively lower yielding, and often less interest rate sensitive, residential mortgages in its loan portfolio. At December 31, 2001, residential mortgage loans comprised 42.2% of total gross loans held for investment. While this percentage increased from 37.8% at December 31, 2000, it is lower than the 43.4% at June 30, 2001, 43.4% at December 31, 1999, and is down significantly from 70.2% at the end of 1997, before the Company's adopted its transformation strategy.

During the first half of 2001, the Company de-emphasized the origination of construction loans and added significant amounts of residential mortgages in response to the slowdown in the national economy, with associated greater concerns for credit quality, and in order to position the Company to benefit from the rapidly declining interest rate environment. By the fourth quarter of 2001, the Company believed that the economy would likely commence recovery some time in 2002 and that the declining interest rate environment was nearing an end, with interest rates then at historically low levels. The Company thus re-commenced actively pursuing a shift toward income property, construction, and business loans by the end of 2001.

The Company's focus on non-residential lending led to the opening of a loan production office in Los Angeles County in the first quarter of 2002. This loan production office is managed by a veteran banker with significant experience in Southern California, long-standing relationships with area developers and property investors, and particular expertise in marketing and underwriting construction and income property credits. The opening of this office will also advance the geographic diversification of the Company's real estate loan portfolio, which has been historically concentrated in the California counties of Santa Cruz, Monterey, and Santa Clara.

At December 31, 2001, certificates of deposits constituted 56.4% of the deposit portfolio, down from 60.0% at December 31, 2000 and 79.3% at the end of 1997. Certificates of deposit would have reflected a smaller percentage of the deposit portfolio at December 31, 2001 if not for the Bank's acquiring an additional net $5.0 million in certificates of deposit through the State of

California Time Deposit Program during 2001, whereby the State of California makes deposits available to support reinvestment back into California communities.

Over the past several years, the Company has emphasized checking and money market accounts in its marketing, new product development, and advertising as a means of cementing its relationship with its customers, decreasing its relative cost of funds, and bolstering non-interest income. The Company plans to introduce Internet banking for businesses in the first quarter of 2002, complementing its successful consumer Internet banking product.

The Company's strategy of transitioning into more of a community commercial bank also incorporates increasing the percentage of the Company's total revenues generated from fees and service charges, as compared to net interest income. In this regard, the Company has expanded its scope of fee based services, altered its pricing, and enhanced the product line offered through Portola.

In order to better serve professionals and businesses in the Company's market area, new and additional commercial business relationship officers, branch sales managers, and professional bankers were hired in 2001. These new employees also enhanced the Company's capacity to better serve its consumer base. The Company's employee mix also shifted in 2001 to reflect the adoption of a current generation, internally operated core data processing system, representing a significant change from the Company's prior external service bureau environment. The new core data processing system is built upon a leading relational database, is open architecture and client / server based, and provides significantly greater customization and flexibility than the prior legacy system. Employees added to the Company in 2001 included new data processing professionals and a new Director of Information Technology with over 20 years of operations and technology experience in the banking industry.

In implementing its strategy, the Company also intends to enhance the services provided to its consumer markets. In 2001, the Company introduced electronic bill payment, bilingual telephone banking, and more highly tiered deposit products whereby individuals can earn higher levels of interest by increasing their balances. In 2002, the Company plans to add one or more consumer relationship products, whereby individuals benefit from expanding their overall relationship with the Company.

The Company intends to complement the new technology implemented in 2001 during the coming year with a new item processing environment, enhanced customer statements, and various ancillary systems such as current generation safe deposit box management software. In addition, the Company plans to actively work with the vendor of its primary data processing system to add enhancements to that software and to ensure that the Company is realizing the best productivity and richest features of that system.

Throughout 2001, the Company maintained its commitment to support the quality of life in the Greater Monterey Bay Area. Employees are encouraged to be involved with local community and service organizations. A significant contribution was made to advance post-secondary education, and other charitable donations of funds or services were conducted throughout the year. The hiring of a Director of Community Relations in 2001 further enhanced the Company's visibility in the Greater Monterey Bay Area, with the Company's being represented at many local chambers of commerce and Rotary organizations, in addition to many special community, charity, and educational events.

A key aspect of the Company's business strategy is to enhance stockholder value. The Company's efforts and achievements in this regard have included:

- Since 1995, the Company has repurchased over 1.2 million of its common shares. During the fourth quarter of 2001, the Company announced a new stock repurchase program with an authorization to acquire an additional 114,035 shares. Under this program, five thousand shares were acquired during the first quarter of 2002 at $16.25 per share.

- The Company's Directors elected to receive their retainer fees in Company common stock during 2001.

- The Company's bylaws specify a minimum stock ownership requirement for all Directors.

- A significant portion of the total compensation for the Company's senior management is stock-based.

- In 2001, shares of the Company's stock were used in lieu of cash as incentive compensation for various Bank middle management.

- In 2001, some members of the Bank's senior management volunteered to accept Company stock in lieu of certain cash base and incentive compensation.

- The Company's employee stock option plan provides that stock options are issued at 110% of the fair market value of the Company's stock on the date of grant, versus the 100% level prevalent in the financial services industry.

- Incentive stock options have been awarded to the vast majority of managers in the Company, thus encouraging alignment of employee interests with those of stockholders.

- Senior management change in control contracts have been modified to present what the Company believes is a better balance between the need to attract and retain well qualified employees and stockholder interests.

- Following the events of September 11, 2001, trading and liquidity in the Company's common stock was adversely impacted by the multiple effects upon investment banking firms with New York City operations. During the fourth quarter of 2001 and early 2002, the Company successfully added several new market makers to enhance the liquidity of the Company's common stock. In addition, the Company temporarily lost equity analyst coverage following September 11, 2001. Coverage by one equity analyst was reinstated in early 2002, and the Company anticipates pursuing coverage by a second equity analyst later in 2002.

In addition, in early 2002, the Company established an expanded relationship with an investment banking firm specializing in the financial services industry as a means of:

- supporting a number of initiatives aimed at increasing stockholder value

- obtaining advice regarding balance sheet, interest rate risk, and capital management

- o acquiring expanded competitive information and market intelligence
- o advising the Board of Directors and Management regarding trends, risks, and tactical and strategic opportunities within the financial services industry

The implementation of the Company's strategy presents various costs and risks. In general, the Company incurred operating and capital expenses in advance of associated revenues, as the human and technology resources necessary to implement the strategic plan must be in place before new sales can be generated. The amount of change concomitant with this strategy, particularly given the relatively rapid pace of implementation undertaken by the Company, presents significant execution risks. Some of these execution risks include exposure in the implementation of new technology and the greater credit risk inherent in consumer and commercial (versus mortgage) lending. The Company has endeavored to mitigate these risks, in part, by recruiting the aforementioned experienced banking professionals and by the hiring of a substantially new senior management team over the past 18 months.

The new senior management team contains individuals with significant experience in credit administration, operations and regulatory compliance, and commercial banking. These senior officers also have prior experience in tactical and strategic transactions designed to maximize stockholder value. The Company has also sought to mitigate the risks inherent in its strategic plan by hiring certain consultants to provide technical assistance and asset quality review.

The Company's Board of Directors has also evolved over the past two years, with new directors adding skills in corporate governance, an appreciation of the importance of advancing stockholder value, and the capacity to refer local business to the Company.

In 2002, the Company intends to continue pursuing the strategy outlined above. Furthermore, the Company plans to explore avenues for further growth in product diversification and market share, including the purchase of banking branches in the Greater Monterey Bay Area or the establishment of one or more de novo branch offices. During the first quarter of 2002, the Company opened a stand alone loan production office in Los Angeles. Management believes that the continued consolidation occurring in the financial services industry may present opportunities to acquire personnel, branches, and customers from institutions being sold.

Susan F. Grill resigned from her position as Director of Retail Banking for Monterey Bay Bank in February, 2002. Ms. Grill's responsibilities were divided among other members of the Bank's management team, until a successor is appointed.

Market Area and Competition

Market Area. The Bank is a community-oriented financial institution that originates residential, multifamily, construction, commercial real estate, consumer, and business loans within its market area. The Bank's deposit gathering and lending markets are concentrated primarily in the communities surrounding its full service offices in the counties of Santa Cruz, Monterey, and Santa Clara in Central California. In 2001, the Company purchased real estate loans secured by California real property primarily located between the San Francisco Bay Area and San Diego as a means of geographically diversifying its loan portfolio and in conjunction with its asset / liability management program. The Company conducts only a minor volume of business outside the State of California.

The economy in the Company's primary market areas in Santa Cruz, Monterey, and Santa Clara Counties has historically been primarily agricultural. However, in recent years, other economic segments have assumed a larger portion of total business activity, caused in part by the continuing southward expansion of the San Francisco Bay Area in general and the technology focused Silicon Valley community in particular. These newer and in some cases relatively rapidly expanding segments include:

- an increasing professional presence, both in commercial property and in residential housing, as the technology companies expand southward, primarily down the Highway 101 corridor
- light manufacturing
- post-secondary education
- tourism and marine biology, especially in the coastal communities on Monterey Bay

The Company's primary market areas were adversely impacted during 2001 by:

- the national recession, with an increase in local unemployment rates
- the difficulties experienced by the technology industry following the significant reduction in the NASDAQ Index in 2000 and 2001 and constrained venture capital financing
- the 2001 mid-summer State of California energy crisis, with continuing effects upon the State's budget
- the impacts of the events of September 11, 2001, especially reduced travel and tourism, which had a particular negative effect upon the hospitality industry

The above factors led to a slowdown in the demand for real estate, which in turn moderated the pace of real estate price appreciation in the Company's primary market areas in 2001 versus the recent past. Certain communities within the Company's primary market area exhibited a slight softening of real estate prices in 2001. The above factors were, however, partially offset by historically low interest rates, limited new construction, and increasing demand for real estate caused by a growing population. The largest impact on real estate prices stemming from the above factors was for very high end residential properties ($1.5 million and above), which the Company serves but does not target market. Home sale results in early 2002 in the Company's primary market area indicated an increasing level of activity versus the same period in 2001. The Company did not foreclose on any real estate collateral in 2001.

The California energy crisis in mid 2001 had only limited near term impact, as the State was able to acquire sufficient energy to avoid recurring and widespread blackouts, consumers and businesses adopted effective conservation measures, and the economic recession curbed demand for power. However, businesses that are relatively energy intensive remain concerned about the long term supply and cost of energy in California, a situation exacerbated by the bankruptcy of the largest power utility in the Company's market area. Consumers experiencing higher energy bills also have less disposable income to spend in the local economy. The energy crisis continues to impact the budget for the State of California, as certain long term supply contracts were signed by the State at prices that were above the current market at the end of 2001. To the extent that the California energy situation continues to affect the State's budget, spending, and potential level and manner of taxation, the Company will continue to be impacted.

The Company has taken steps to reduce its energy consumption, including a reduction in exterior lighting and electric signage, reduced interior lighting in certain areas, and proactive efforts to power off inactive computers and other machines. In 2001, the Company installed a larger natural gas fueled generator at its administrative headquarters that produces sufficient electricity to power the entire building, including the core computer network, in the event of an external electricity reduction or outage.

Throughout 2001, many large national corporations with operations in Central California announced significant layoffs. In addition, many local technology companies shut down due to a combination of weak (or negative) earnings, limited liquidity, or a lack of access to additional capital. While the demand for labor in Central California slowed in 2001 versus the immediate preceding years, unemployment remained moderate by historical standards.

Unlike 1999 and the first half of 2000, the local economy did not materially benefit in 2001 from a significant rise in stock and stock option wealth among consumers, including workers in the Silicon Valley area of Santa Clara County.

Lease rates for many types of commercial real estate declined significantly in the San Francisco Bay Area during 2001, reversing strong rises in 1999 and early 2000 fueled by the Internet boom. While the Company originates and purchases commercial real estate loans in the San Francisco Bay Area, Management did not generally pursue loans based upon the high lease rates and market values during 1999 and 2000. The Company had no classified loans at December 31, 2001 that were secured by commercial real estate in the San Francisco Bay Area.

Vacancy rates increased and average effective room rates declined for California hotels and motels in 2001, with the trend worsening after the events of September 11, 2001. As subsequently discussed, the Company has a concentration in real estate loans secured by hotels and motels, which the Company intends to reduce in 2002.

The economy in some segments of the Company's primary market area remains seasonal. These segments include tourism and agriculture, both of which slow during the winter months.

Competition. The banking and financial services business in California generally, and in the Bank's market areas specifically, is highly competitive. The increasingly competitive environment is a result of many factors including, but not limited to:

- the rise of the Internet, whereby the Bank must more frequently compete with remote entities soliciting customers in its primary market areas via web based advertising and product delivery, especially for certificates of deposit and residential mortgages

- the significant consolidation among financial institutions which has occurred over the past several years, resulting in a number of substantially larger competitors with greater resources than the

Company

- the increasing integration among commercial banks, insurance companies, securities brokers, and investment banks
- the continued growth and market share of non-bank financial services providers that often specialize in a single product line such as credit cards or residential mortgages
- the introduction of new technologies which may bypass the traditional banking system for funds settlement
- the addition of bank subsidiaries by firms not historically in the financial services business, but with significant consumer reach
- the continued tax relief enjoyed by credit unions in serving the consumer market combined with a trend toward loosening restrictions on credit union activities and requirements for credit union membership

The Company competes for loans, deposits, fee based products, and customers for financial services with commercial banks, savings and loans, credit unions, thrift and loans, mortgage bankers, securities and brokerage companies, insurance firms, finance companies, mutual funds, and other non-bank financial services providers. Many of these competitors are much larger than the Bank in total assets, market reach, and capitalization; and enjoy greater access to capital markets and can offer a broader array of products and services than the Bank presently markets.

Two banks, each with several billion dollars in assets and more diversified revenue sources, present particular competition to the Company. Both these banks follow the "super community banking" business model, whereby multiple community banks are owned and operated under a unified umbrella organization. Both of these firms have expanded rapidly in recent years and have acquired community banks in the Company's primary market areas. These firms have comparatively highly valued common stock and access to far greater amounts of capital than the Company. These firms also benefit from greater economies of scale than the Company. One of these banks recently announced the acquisition and pending consolidation of two branches that compete directly with the Company's offices in Watsonville and Monterey, California. Acquisitions by these two banks have resulted in the Company's being the largest truly local financial institution in many of its markets.

The Company also competes increasingly frequently with another community bank, which has over the past year opened de novo offices in some of the same communities served by the Company. In 2001, the Company experienced particular competition for retail deposits from the three largest thrifts that operate in California. These large thrifts benefited from the declining interest rate environment, with expanding net interest margins resulting from their net liability sensitivity. These thrifts used their expanding margins to bid up retail deposit rates in an effort to build market share.

In order to compete with other financial services providers, the Company relies upon:

- local community involvement, contributions, and visibility
- personal service and the resulting personal relationships of its staff and customers

- referrals from satisfied customers, employees, and directors
- the development and sale of specialized products and services tailored to meet its customers' needs
- local and fast decision making

In addition, Management considers the Company's reputation for financial strength and competitive services, as developed over 76 years of local Company history, as a competitive advantage in attracting and retaining customers within its primary market area.

Risk Factors That May Affect Future Results

The following discusses certain factors that may affect the Company's financial results and operations and should be considered in evaluating the Company. The two general categories of greatest risk faced by the Company are credit risk and interest rate risk, both of which are inherent to community banking.

Ability Of The Company To Execute Its Business Strategy. The financial performance and profitability of the Company will depend, in large part, on its ability to favorably execute its business strategy in converting from a relatively traditional savings & loan to a community based financial services firm. This evolution entails risks in, among other areas, technology implementation, market segmentation, brand identification, banking operations, and capital and human resource investments. Accordingly, there can be no assurance that the Company will be successful in its business strategy.

Economic Conditions And Geographic Concentration. The Company's operations are located in Central and Northern California and are concentrated in Santa Cruz, Monterey, and Santa Clara Counties. Although Management has diversified the Company's loan portfolio into other California counties, the majority of the Company's credits remain concentrated in the three primary counties. As a result of this geographic concentration, the Company's results depend largely upon economic and real estate market conditions in these areas. Deterioration in economic or real estate market conditions in the Company's primary market areas could have a material adverse impact on the quality of the Company's loan portfolio, the demand for its products and services, and its financial condition and results of operations. In addition, because the Company does not require earthquake insurance in conjunction with its real estate lending, an earthquake with an epicenter in or near the Company's primary market areas could also significantly adversely impact the Company's financial condition and results of operations.

Interest Rates. By nature, all financial institutions are impacted by changing interest rates, due to the impact of such upon:

- the demand for new loans
- prepayment speeds experienced on various asset classes, particularly mortgage backed securities and residential loans
- credit profiles of existing borrowers
- rates received on loans and securities

o rates paid on deposits and borrowings

As presented under "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations" and under "Item 7a. Quantitative and Qualitative Disclosure of Market Risk", the Company is financially exposed to parallel shifts in general market interest rates, changes in the relative pricing of the term structure of general market interest rates, and relative credit spreads. Therefore, significant fluctuations in interest rates may present an adverse effect upon the Company's financial condition and results of operations.

Government Regulation And Monetary Policy. The financial services industry is subject to extensive federal and state supervision and regulation. Significant new laws, changes in existing laws, or repeals of present laws could cause the Company's financial results to materially differ from past results. Further, federal monetary policy, particularly as implemented through the Board of Governors of the Federal Reserve System, significantly affects credit conditions for the Company, and a material change in these conditions could present an adverse impact on the Company's financial condition and results of operations.

Competition. The financial services business in the Company's market areas is highly competitive, and is becoming more so due to technological advances (particularly Internet-based financial services delivery), changes in the regulatory environment, and the significant consolidation that has occurred among financial services providers. Many of the Company's competitors are much larger in total assets and market capitalization, enjoy greater liquidity in their equity securities, have greater access to capital and funding, and offer a broader array of financial products and services. In light of this environment, there can be no assurance that the Company will be able to compete effectively. The results of the Company may materially differ in future periods depending upon the nature or level of competition.

Credit Quality. A significant source of risk arises from the possibility that losses will be sustained because borrowers, guarantors, and related parties may fail to perform in accordance with the terms of their loans. The Company has adopted underwriting and credit monitoring procedures and credit policies, including the establishment and review of the allowance for loan losses, that Management believes are appropriate to control this risk by assessing the likelihood of non performance, tracking loan performance, and diversifying the credit portfolio. Such policies and procedures may not, however, prevent unexpected losses that could have a material adverse effect on the Company's financial condition or results of operations. Unexpected losses may arise from a wide variety of specific or systemic factors, many of which are beyond the Company's ability to predict, influence, and control.

State Of California Budget Crisis. In part due to the handling of the energy crisis and also due to the onset of the national recession, the State of California is currently facing a substantial budget deficit. A combination of reductions in State provided services and increases in the level and nature of taxation might result, which could present an unfavorable impact upon the Company's business, financial condition, and results of operations. At December 31, 2001, the State of California maintained $19.0 million in deposits with the Company. If the State were to withdraw these deposits, replacement funding would likely be more expensive.

Technology Industry And Technological Change. The pace of economic activity, the demand and pay rates for labor, and real estate valuations in many of the Company's primary market areas are impacted by the technology industry. A prolonged slowdown in the technology business would therefore likely have an adverse impact on the Company's financial condition and results of operations. New products and delivery mechanisms being developed as a result of new technologies present the potential for bypassing the historic bank payments settlement process. As such, the Company is exposed to various associated financial risks.

Terrorism And The War On Terrorism. Tourism constitutes a significant component of the economy in the Company's primary market areas. In addition, the Company maintains a concentration of loans extended to the hospitality industry. Should new terrorist actions or the continued war on terrorism continue to or more dramatically curtail travel and tourism, the Company's financial condition and results of operations could be significantly impacted.

Other Risks. From time to time, the Company details other risks with respect to its business and financial results in its filings with the Securities and Exchange Commission.

Lending Activities

General. The Company originates a wide variety of loan products. Loans originated by the Company are subject to federal and state laws and regulations. Interest rates charged by the Company on loans are affected by the demand for such loans and the supply of money available for lending purposes and the rates offered by competitors. These factors are, in turn, affected by, among other things, economic conditions, monetary policies of the federal government, including the Federal Reserve Board, and legislative tax policies. The Company targets certain lending toward low to moderate income borrowers as part of its commitment to serve its local communities.

At December 31, 2001, the Company's net loan portfolio held for investment totaled $465.9 million. This represented the highest total in the Company's history. The vast majority of this portfolio was associated with real estate of various types. In 2001, real estate loan originations, including funding commitments for construction loans, totaled $173.2 million and real estate loan purchases, including funding commitments for construction loans, totaled $60.2 million. Activity in 2001 was supported by an active mortgage refinance market throughout most of the year, spurred by the eleven rate decreases implemented by the Federal Reserve in 2001. Of the $60.2 million in real estate loan purchases in 2001, $47.3 million occurred in the first half of the year. All real estate loan purchases in the second half of the year were for mortgages secured by non-residential properties, as the Company pursued its targeted loan mix and sought more interest rate sensitive assets.

Net loans as a percentage of total assets increased from 80.6% at December 31, 2000 to 86.8% at December 31, 2001. Allocating a greater percentage of its total assets to loans is fundamental to the Company's strategies of effectively supporting the financing needs of its local communities, increasing its net interest margin, and effectively leveraging the Company's capital position.

The Company accepts loan applications generated through brokers for most of its product line. Broker referred loans are underwritten in the same manner as direct originations. The Company encourages its employees to refer and solicit loan business as an integral part of functioning as a community bank. Employees receive various types of awards or commissions based upon the volume and nature of business booked.

In purchasing individual loans or pools of loans, the Company underwrites each loan in a manner similar to its internal originations. The Company generally purchases income property loans on a servicing released basis in order to facilitate more effective credit management and in order to acquaint such borrowers with the other products and services offered by the Company. The residential mortgages purchased by the Company in 2001 were substantially all servicing retained by the seller.

The Company also pursues acquiring loan participations from and selling loan participations to other California community banks and other financial institutions. In acquiring participations, the Company underwrites each credit in a manner similar to that followed for its own internal loan production. The Company sells loan participations in order to diversify its credit risk and in order to remain below its regulatory limitation for loans to one borrower. In general, most of the Company's loan participations are for construction loans.

The Company requires title and hazard (fire, and, if applicable, flood) insurance for all real estate loans. The Company does not require earthquake insurance for real estate loans. More detailed information regarding the Company's lending activity is included in the following paragraphs that present activity by loan product category.

Residential One To Four Unit Mortgage Lending. The Company originates fixed rate, adjustable rate, and hybrid (fixed for a period, and then adjustable) mortgage loans secured by one to four family residential properties. Adjustable rate mortgage loans have interest rates that adjust monthly, semiannually, or annually and reprice based upon various indices, primarily the 11th FHLB District Cost of Funds Index ("COFI") or the US Treasury One Year Constant Maturities Index ("1 Year CMT"). In 2002, the Company intends to commence originating residential mortgages tied to the MTA index, which is equivalent to the twelve month rolling average of the 1 Year CMT index. The MTA index is utilized by a number of the Company's primary competitors and is often preferred by consumers due to its limited volatility relative to the 1 Year CMT index. The Company's hybrid and adjustable rate residential mortgages typically contain various periodic and lifetime rate caps, and also lifetime rate floors. The Company regularly adjusts its loan products to meet changing customer needs and to respond to the marketplace.

The majority of loan originations are to existing or past customers and members of the Bank's local communities. The Company also originates one to four family residential construction loans for both owner occupants and developers / contractors ("speculative construction loans"), and residential mortgages secured by non-owner occupied one to four family properties acquired as an investment by the borrower. The Company provides escrow (impounds) services as requested by its customers and generally for those loans in excess of 80.0% loan to value.

At December 31, 2001, the Company maintained $204.8 million in residential permanent mortgages, representing 42.2% of gross loans held for investment. This compares to $160.2 million in permanent residential mortgages a year earlier, which then constituted 37.8% of gross loans held for investment. In 2002, the Company plans to reduce the concentration of residential mortgages in its loan portfolio in favor of other types of relatively higher yielding, and often more interest rate sensitive, loans.

The Company generally sells its fixed rate residential production into the secondary market on a servicing released basis. These sales are conducted as part of the Company's asset / liability management strategy. The sales are generally on a servicing released basis because the Company believes the servicing is more valuable to high volume, low marginal cost servicers.

From time to time, based on its asset / liability strategy, the Company purchases residential mortgage loans originated by others. In the first half of 2001, the Company purchased residential hybrid loans in order to take advantage of the declining interest rate environment and in order to more effectively leverage the Company's capital. In 2002, depending upon loan origination volume and mix, the Company may consider the sale of certain hybrid or adjustable rate residential mortgages into the secondary market.

The majority of the residential loans at December 31, 2001 were secured by properties located within the Company's primary market area in Central California. At December 31, 2001, 7.4% of the Company's one to four family mortgage loans had fixed terms and 93.6% had adjustable rates, including adjustable rate loans that have a fixed rate for an initial period. The Company offers a variety of adjustable rate residential loan products, including an "easy qualifier" loan with more limited documentation required than other mortgages. The Company began originating loans subject to negative amortization in 1996. Negative amortization involves a greater risk to the Company because during a period of high interest rates the loan principal may increase above the amount originally advanced. However, the Company believes that the risk of default on these loans is mitigated somewhat by negative amortization caps, underwriting criteria, relatively low loan to value ratios, and the stability provided by payment schedules. At December 31, 2001, the Company's residential loan portfolio included $26.3 million of loans subject to negative amortization.

The Company originates one to four family residential mortgage loans in amounts up to 80% of the lower of the appraised value or the selling price of the property securing the loan, and up to 97% of the appraised value or selling price if private mortgage insurance is obtained. Mortgage loans originated by the Company generally include due on sale clauses which provide the Company with the contractual right to deem the loan immediately due and payable in the event the borrower transfers ownership of the property without the Company's consent. Due on sale clauses are an important means of adjusting the rates on the Company's mortgage loan portfolio and the Company has generally exercised its rights under these clauses.

The five largest residential loans in the Company's portfolio at December 31, 2001 are presented in the following table. Original loan to value ratio equals the loan's original principal balance divided by the original appraisal amount obtained at the time of loan origination. Current loan to value ratio equals the December 31, 2001 principal balance divided by the original appraisal amount obtained at the time of loan origination.

(Dollars In Thousands)

Principal Balance Outstanding	Year Of Origination/ Acquisition	Property Location	Original Loan To Value Ratio	C L Value
$ 3,125	2000	Carmel, California	50%	
$ 2,223	1999	Monte Sereno, California	70%	
$ 2,008	2000	Monterey, California	70%	
$ 1,743	2001	Saratoga, California	26%	
$ 1,708	2000	Pebble Beach, California	65%	

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* Loan product permitting negative amortization

Multifamily Lending. The Company offers hybrid and adjustable rate permanent multifamily (five or more units) real estate loans secured by real property in California. The Company also periodically extends construction financing to builders of multifamily housing. From time to time, the Company extends loans secured by mixed use property in more urban areas, which typically present commercial (generally retail) space in one part of the building (often street level) and residential units in other parts of the building.

Apartment rents and multifamily property valuations have generally increased in California during the past several years, as supply has not expanded with the same speed as population growth, leading to greater demand for units and thus higher market rents and lower vacancies.

Permanent loans on multifamily properties typically present maturities of up to 30 years. Factors considered by the Company in reaching a lending decision on such properties include the net operating income of the mortgaged premises before debt service and depreciation, the debt service ratio (the ratio of net earnings to debt service), the ratio of the loan amount to appraised value, and the financial profile of any guarantors. Pursuant to the Company's underwriting policies, multifamily hybrid and adjustable rate mortgage loans are generally originated in amounts up to 75% of the appraised value of the underlying properties. The Company generally requires a debt service ratio of at least 1.10. Properties securing loans are appraised by an independent appraiser. Title insurance is required on all loans.

When evaluating the qualifications of the borrower for a multifamily loan, the Company considers the financial resources and income level of the borrower, the borrower's experience in owning or managing similar property, and the Company's lending experience with the borrower. The Company's underwriting policies require that the borrower provide evidence of ability to repay the mortgage on a timely basis and maintain the property from current rental income. In evaluating the creditworthiness of the borrower, the Company generally reviews the borrower's financial statements, employment, tax returns, and credit history, as well as other related documentation.

Loans secured by apartment buildings and other multifamily residential properties are generally larger and involve a greater degree of risk than one to four family residential loans. Because payments on loans secured by multifamily properties are often dependent on successful operation or management of the properties, repayment of such loans may be subject to a greater extent to adverse conditions in the real estate market or the economy. The Company seeks to mitigate these risks through its underwriting policies, which require such loans to be qualified at origination on the basis of the property's income and debt coverage ratio. The Company also attempts to limit its risk exposure by requiring annual operating statements on the properties and by acquiring personal guarantees from the borrowers when available.

There is a limited volume of multifamily properties in the Company's primary market area due to the more rural aspects of many local communities. Therefore, in conjunction with its business strategy, the Company in 2002 intends to continue increasing its multifamily real estate lending within the State of California. At December 31, 2001, the Company's portfolio of multifamily loans totaled $103.9 million, or 21.4% of gross loans receivable held for investment. This compares to $76.7 million, or 18.1% of gross loans receivable held for investment, at December 31, 2000. The Company acquired multifamily loans from direct originations, broker referrals, and pool purchases during 2001. It is expected that all of these sources will be utilized in 2002.

The five largest multifamily real estate loans in the Company's portfolio at December 31, 2001 are presented in the following table:

(Dollars In Thousands)

Principal Balance Outstanding	Year Of Origination / Acquisition	Property Location	Original Loan To Value Ratio	Val
$ 3,959	2001	Van Nuys, California	64%	
$ 2,595	2001	San Francisco, California	69%	
$ 2,500	2001	West Hollywood, California	74%	
$ 2,298	2001	Oakland, California	74%	
$ 1,832	2001	San Francisco, California	74%	

Because the primary marketplace the Company serves has a limited volume of multifamily properties, the Company intends to continue pursuing multifamily real estate loans secured by properties located throughout California. The Company's strategy in this regard includes purchasing participations in multifamily loans originated by experienced, local lenders with a favorable record of quality loan origination. The acquisition and origination of multifamily loans throughout California presents the Company with geographic diversification, but also introduces credit exposure due to the greater demands of monitoring the demand for and value of multifamily real estate in a greater number of market areas.

Commercial & Industrial Real Estate Lending. The Company originates both permanent and construction loans secured by commercial & industrial real estate located primarily in California. The Company's underwriting procedures provide that commercial & industrial real estate loans may generally be made in amounts up to the lesser of 65% of the appraised value of the property or up to a debt service coverage ratio of 1.20. Permanent loans may be made with terms up to 25 years and are typically hybrid (fixed for three to five years, then adjustable) or adjustable based upon the 1 Year CMT or COFI indices. The Company's underwriting standards and credit review procedures on commercial & industrial real estate loans are similar to those applicable to multifamily loans. The Company considers the property's net operating income, the loan to value ratio, the presence of guarantees, and the borrower's expertise, credit history, and financial status.

The Company's commercial & industrial real estate loans are typically secured by properties such as retail stores, retail strip centers, office buildings, and light manufacturing facilities. The Company typically does not extend loans for the acquisition or refinance of major manufacturing facilities, as that type of real estate generally encompasses larger loans than the Company makes. The Company also takes various steps to attempt to avoid extending loans secured by commercial & industrial real estate that presents significant environmental issues, such as groundwater contamination or the presence of toxic chemicals. However, despite these steps, including environmental reviews, there can be no assurance that the Company can avoid financial exposure resulting from environmental issues associated with loan collateral.

The majority of the commercial & industrial real estate loans are secured by property located in Northern and Central California. However, the Company has in the past several years pursued participations on and purchases of commercial & industrial real estate loans with experienced, local lenders in the greater San Diego and Los Angeles markets as a means of increasing loans outstanding and geographically diversifying the Company's loan portfolio.

At December 31, 2001, the Company's permanent commercial & industrial real estate loan portfolio totaled $110.0 million, or 22.7% of gross loans held for investment. This compares to $102.3 million, or 24.1% of gross loans held for investment, at December 31, 2000. This nominal expansion is consistent with the Company's business strategies of:

- increasing the percentage of its balance sheet represented by income property loans
- meeting the real estate and business financing needs of businesses and individuals whose business is domiciled in real estate owned by the borrower
- seeking comprehensive relationships with businesses in the Company's primary market areas, including the placement of deposits with the Company and the Company's provision of funds transfer services

The five largest commercial & industrial real estate loans in the Company's portfolio at December 31, 2001 are presented in the following table:

(Dollars In Thousands)

Principal Balance Outstanding	Year Of Origination / Acquisition	Type Of Property	Property Location
$ 4,957	1999	Hotel	Dublin, California
$ 3,381	2001	Mini-Storage Facility	San Jose, California
$ 2,919	2001	Office Building	Simi Valley, California
$ 2,794	1999	Motel	Aptos, California
$ 2,720	2000	Office Building	Gilroy, California

At December 31, 2001, the Company had $30.8 million in outstanding loans secured by hotel / motel properties. None of these loans were construction loans. The Company is actively monitoring these loans, as the hospitality industry experienced particular difficulties in the second half of 2001 due to the national recession, a reduction in business travel, and the slowdown in tourism and travel following the events of September 11, 2001. The $4.96 million hotel loan in the above table is secured by a nationally branded hotel. During 2002, the Company intends to decrease its lending concentration in loans secured by hotels / motels.

Loans secured by commercial & industrial real estate properties, like multifamily loans, are generally larger and involve a greater degree of risk than one to four family residential mortgage loans. Because payments on loans secured by commercial real estate properties are often dependent on successful operation or management of the properties, repayment of such loans may be significantly subject to adverse conditions in the properties' management or real estate markets in general or particular to a subject property. The Company seeks to mitigate these risks through its underwriting standards and credit review policy, which requires annual operating statements for each collateral property. The Company also participates larger commercial & industrial real estate loans with other financial institutions as a means of diversifying its credit risk and remaining below the Bank's regulatory limit on loans to one borrower.

Commercial & industrial real estate loans can present various environmental risks, as such properties are sometimes located on sites or in areas where various types of pollution may have historically occurred. The Company takes various steps to attempt to avoid extending loans secured by commercial & industrial real estate that presents significant environmental issues, such as groundwater contamination or the presence of toxic chemicals. However, despite these steps, there can be no assurance that the Company can avoid financial exposure resulting from environmental issues associated with loan collateral. The Company attempts to mitigate environmental risk via surveys, reports, and, in some cases, testing; in addition to using a limited list of pre-approved appraisers. In addition, Company lending staff directly inspect most commercial & industrial real estate properties on which the Company lends.

Commercial & industrial real estate can also be impacted by changing government regulation, with a potential associated impact on the market value of the collateral securing the Company's loans.

Construction Lending. The Company originates construction loans for the acquisition and development of property. Collateral has been historically concentrated in residential properties, both owner occupied and speculative (i.e. not being built by an owner occupant, but perhaps pre-sold to third parties). In addition, the Company makes construction loans for the development and rehabilitation of apartments and commercial buildings.

Construction financing is generally considered to involve a higher degree of risk than long-term financing on improved, occupied real estate. The Company's risk of loss on construction loans depends largely upon:

- the accuracy of the initial estimate of the property's value at completion of construction or development
- the accuracy of the estimated cost of construction
- the borrower's ability to complete the construction project within estimated timeframes
- the market demand for the subject property at the completion of construction
- the ability of tenants, if any, to honor lease obligations for the subject property
- the availability of permanent financing for the subject property at the conclusion of the construction period

If the estimate of construction costs proves to be inaccurate, the Company may have to advance funds beyond the amount originally committed to permit completion of the project and to protect its security position. The Company may also be confronted, at or prior to maturity of the loan, with a project with insufficient value to ensure full repayment. The Company's underwriting, monitoring, and disbursement practices with respect to construction financing are intended to ensure that sufficient funds are available to complete construction projects. The Company attempts to limit its risk through its underwriting procedures, by using only approved, qualified appraisers, and by dealing with qualified builders / borrowers. The Company also participates larger construction loans with other financial institutions as a means of diversifying its credit risk and remaining below the Bank's regulatory limit on loans to one borrower.

The Company's construction loans typically have adjustable rates and terms of 12 to 18 months. The Company originates one to four family and multifamily residential construction loans in amounts up to 80% of the appraised value of the property. Land development loans are determined on an individual basis, but in general they do not exceed 70% of the actual cost or current appraised value of the property, whichever is less. Loan proceeds are disbursed in increments as construction progresses and as inspections warrant.

At December 31, 2001, the Company had gross construction and land development loans totaling $38.5 million, on which there were undisbursed loan funds of $12.6 million. At December 31, 2000, the Company had gross construction and land development loans totaling $59.1 million, on which there were undisbursed loan funds of $26.6 million. The gross balance of construction loans as a percentage of gross loans held for investment thus declined from 13.9% at December 31, 2000 to 7.9% at December 31, 2001.

The decline in construction loans during 2001 resulted from payoffs from completed projects not being replaced by the inflow of new business. The Company intentionally curtailed construction lending during most of 2001 in response to concerns about the national recession. In general, the Company's business strategy is, however, to increase the construction loan portfolio and to have construction loans represent a greater portion of total assets. The Company has strategically targeted increased construction lending because of the interest rate sensitivity of the loans, the Company's experience in this type of lending, the yields available from this type of lending, and, in the case of owner residential construction loans, the strong customer bond developed in financing the building of someone's home.

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The five largest construction loans in the Company's portfolio at December 31, 2001 are presented in the following table:

(Dollars In Thousands)

Construction Commitment Amount	Year Of Origination / Acquisition	Type Of Construction	Property Location
$ 5,075	2000	Light Industrial	Fremont, California
$ 5,000	2000	Apartments	Roseville, California
$ 4,436	2000	Speculative Residential	Monterey, California
$ 4,000	2001	Speculative Residential	Rancho Mirage, California
$ 2,111	2001	Speculative Residential	Hillsborough, California

Because construction loans are generally larger and more complex than typical residential mortgages, they present a greater degree of credit risk. The

Company attempts to control this credit risk through its underwriting and funds disbursement processes. In addition, it is the Company's strategy to, over time, build a series of strong relationships with local developers / builders / contractors with whom the Company has detailed financial knowledge and receives a steady stream of repeat business.

Land Lending. The Company offers loans secured by land, generally located in its immediate marketplace. The types of land generally considered by the Company are suitable for residential development or are demarcated residential lots. The Company does not extend loans on agricultural land where repayment of the loan is dependent upon crop sales.

At December 31, 2001, land loans totaled $11.9 million, or 2.5% of gross loans held for investment. This compares to land loans totaling $16.3 million, or 3.8% of gross loans held for investment, at December 31, 2000.

The five largest land loans in the Company's portfolio at December 31, 2001 are presented in the following table. These five loans constituted almost one-half of the Company's total portfolio of land loans, as measured by principal balance, at December 31, 2001.

(Dollars In Thousands)

Principal Balance Outstanding	Year Of Origination / Acquisition	Type Of Land	Property Location
$ 1,500	2001	Residential Subdivision	Monterey, California
$ 1,320	2001	Residential Lots	Los Gatos, California
$ 1,200	2000	Residential Lots	Morgan Hill, California
$ 929	1999	Residential Subdivision	Monterey, California
$ 720	2001	Residential Subdivision	Monterey, California

The three land loans in the above table secured by real estate in Monterey are associated with various parcels within an upscale residential development. The Company has lent money secured by parcels, lots, and homes within this development for the past several years.

Because land and lots are generally less readily marketable than residential real estate, lending on land presents additional risks not present in residential mortgages. The market value of land and lots can be more susceptible to changes in interest rates, economic conditions, or local real estate markets than the market value for homes. Zoning changes by various government authorities may also impact the value and marketability of certain types of land. To mitigate these risks, the Company generally restricts land and lot loans to its primary local market areas, where the Company has the most thorough understanding of land values and trends in the demand for land.

Business Lending. The Company offers a wide variety of business loans, both in the form of lines of credit and amortizing term loans. The majority of the Company's business loans are collateralized by business assets. Such collateral is typically comprised of accounts receivable, inventory, or equipment. In addition, the Company obtains a deed of trust on real estate as additional collateral for certain business loans and generally pursues personal guarantees from principals of closely held businesses. Business lending is generally considered to involve a higher degree of risk than the financing of real estate, primarily because security interests in the collateral are more difficult to perfect and the collateral may be difficult to obtain or liquidate following an uncured default. Business loans typically offer relatively higher yields, short maturities, and variable interest rates. The availability of such loans enables existing and potential business depositors to establish a more complete financial relationship with the Company.

The Company arranges courier service for the collection of deposits from business customers, and in 2002 plans to introduce Internet banking for businesses. For closely held businesses, the Company pursues a marketing objective of obtaining both the personal and commercial banking business from the principals. The Company believes that multiple benefits arise from establishing strong relationships with and thoroughly understanding customers. These benefits include the ability to offer more proactive and effective financial solutions and the opportunity to mitigate credit losses through the timely receipt of key information.

The Company attempts to reduce the risk of loss associated with business lending by closely monitoring the financial condition and performance of its customers. Each business loan customer is assigned to a commercial banking relationship officer. The relationship officer is responsible for monitoring the financial condition of the borrower, developing solutions to the financial needs of the customer, facilitating the growth of the customer's business, and expanding the customer's overall business relationship with the Company. The Company hired several commercial banking relationship officers in 2001, and the Company's business strategy envisions business loans representing a greater percentage of total assets in the future.

The Company also attempts to mitigate the risk inherent in business lending by having third parties review the credits on a periodic basis. In 2002, the Company plans to participate larger business loans with other community banks as a means of diversifying credit risk and remaining below the Bank's regulatory limit on loans to one borrower. The Company also intends to seek similar participations from other California community banks.

At December 31, 2001, the Company had business term loans totaling $3.2 million and drawn balances against business lines of credit totaling $5.7 million. In the aggregate, business loans comprised 1.8% of gross loans held for investment at December 31, 2001. In comparison, the Company had a total of $3.1 million in business loans outstanding at December 31, 2000.

The five largest business loans in the Company's portfolio at December 31, 2001 are presented in the following table:

(Dollars In Thousands)

Line Of Credit Commitment Amount	Year Of Origination / Acquisition	Type Of Business	Business Location
$ 2,000	2001	Semiconductor Equipment	Scotts Valley, California
$ 1,500	2001	Packaging Materials	Soquel, California
$ 1,000	2001	Law Firm	Los Angeles, California
$ 1,000	2001	Industrial Gases	Watsonville, California
$ 600	2001	Fiber Optic Services	Santa Cruz, California

All of the above business loans are associated with firms in the Company's primary market area with the exception of the loan to the law firm, which resulted from a longstanding relationship between the principals and Management.

Loan Approval Procedures And Authority. The Board of Directors has ultimate responsibility for the lending activity of the Company and establishes the lending policies of the Company, including the appraisal policy and credit approval authorities. The Board of Directors also approves all appraisers used by the Company. As of December 31, 2001, the Board of Directors has authorized the following loan approval authorities:

Real Estate Loans

(1) Residential mortgage loans in amounts up to the federal agency (e.g. Federal National Mortgage Association or "FNMA") conforming limit may be approved by the Company's staff underwriters.

(2) Loans in excess of the agency conforming limits and up to $500,000 may be approved by the underwriting / processing manager.

(3) Loans in excess of $500,000 and up to $750,000 may be approved by the real estate loan administrator.

(4) Loans in excess of $750,000 and up to $1,000,000 require the approval of the Chief Executive Officer / President, Chief Loan Officer, or the Director of Commercial Banking.

(5) Loans in excess of $1,000,000 and up to $2,000,000 require the approval of two of the Chief Executive Officer / President, Chief Loan Officer, or Director of Commercial Banking.

(6) Loans in excess of $2,000,000 require the approval of the Board of Directors Loan Committee.

Non-Real Estate Loans

(1) Overdraft lines of credit of up to $1,500 require the approval of the underwriting / processing manager or the real estate loan administrator.

(2) Loans up to $500,000 require the approval of the Chief Executive Officer / President, Chief Loan Officer, or Director of Commercial Banking.

(3) Loans in excess of $500,000 require the approval of the Board of Directors Loan Committee.

The loan origination process requires that upon receipt of a completed loan application, a credit report is obtained and certain information is verified. If necessary, additional financial information is obtained from the prospective borrower. An appraisal of the related real estate is performed by an independent, licensed appraiser. If the original loan exceeds 80% loan to value on a first trust deed loan or private mortgage insurance is required, the borrower is required to make payments to a loan impound account from which the Company makes disbursements for property taxes and insurance.

Loan Portfolio Composition. The following table presents the composition of the Company's net loans receivable held for investment at the dates indicated.

	At December 31,						
	2001		2000		1999		
	Amount	%	Amount	%	Amount	%	Amou
					(Dollars In Thousands)		
Loans secured by real estate							
Residential one to four unit	$204,829	42.2%	$160,155	37.8%	$168,465	43.4%	$181,
Multifamily five or more units	103,854	21.4%	76,727	18.1%	42,173	10.9%	33,
Commercial and industrial	109,988	22.7%	102,322	24.1%	72,344	18.6%	39,
Construction	38,522	7.9%	59,052	13.9%	79,034	20.3%	51,
Land	11,924	2.5%	16,310	3.9%	13,930	3.6%	7,
Sub-total loans secured by real estate	469,117	96.7%	414,566	97.8%	375,946	96.8%	314,
Other loans							
Home equity lines of credit	6,608	1.4%	5,631	1.3%	3,968	1.0%	3,
Other consumer loans	372	0.1%	669	0.2%	587	0.2%	
Business term loans	3,163	0.6%	1,641	0.4%	6,670	1.7%	6,
Business lines of credit	5,680	1.2%	1,438	0.3%	1,027	0.3%	
Sub-total other loans	15,823	3.3%	9,379	2.2%	12,252	3.2%	11,
Total gross loans	484,940	100.0%	423,945	100.0%	388,198	100.0%	325,
(Less) / Plus							
Undisbursed loan funds	(12,621)		(26,580)		(23,863)		(24,
Unamortized premiums & Discounts	435		21		134		
Deferred loan fees, net	(202)		(202)		(281)		(
Allowance for loan losses	(6,665)		(5,364)		(3,502)		(2,
Total loans held for investment, net	$465,887		$391,820		$360,686		$298,

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Loan Maturity Profile. The following table shows the contractual maturities of the Company's gross loans held for investment at December 31, 2001.

	At December 31, 2001			
	2002	2003 Through 2006	2007 And Thereafter	Total Gross Loans
	(Dollars In Thousands)			
Residential one to four unit	$ --	$ 399	$204,430	$204,829
Multifamily five or more units	19	203	103,632	103,854
Commercial and industrial real estate	354	5,118	104,516	109,988
Construction	35,701	2,821	--	38,522
Land	2,754	9,170	--	11,924
Home equity lines of credit	--	132	6,476	6,608
Other consumer loans	223	--	149	372
Business term loans	175	2,676	312	3,163
Business lines of credit	3,011	2,669	--	5,680
Total	$ 42,237	$ 23,188	$419,515	$484,940

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The following table presents the Company's gross loans held for investment at December 31, 2001, segregating those with fixed versus adjustable interest rates and also isolating those loans with contractual maturities less than or equal to and greater than one year.

	Matures In 2002		Matures After 2002	
	Fixed	Adjustable	Fixed	Adjustable
			(Dollars In Thous	
Residential one to four unit	$ --	$ --	$ 15,215	$189,614
Multifamily five or more units	19	--	871	102,964
Commercial and industrial real estate	--	354	2,013	107,621
Construction	3,680	32,021	--	2,821
Land	--	2,754	--	9,170
Home equity lines of credit	--	--	--	6,608
Other consumer loans	223	--	149	--
Business term loans	85	90	89	2,899
Business lines of credit	--	3,011	--	2,669
Total	$ 4,007	$ 38,230	$ 18,337	$424,366
Percent of gross loans outstanding	0.8%	7.9%	3.8%	87.5%

Loan Commitments. At December 31, 2001, the Company had $24.4 million in outstanding commitments to originate loans and lines of credit, not all of which were rate locked at that time. These commitments had expiration dates or other termination clauses. Because customers do not always accept loan commitments (e.g. perhaps as a result of applying to more than one lender), the Company anticipates future cash requirements associated with these commitments to be less than the $24.4 million total.

At December 31, 2001, the Company had made available various business, personal, and residential lines of credit totaling $25.8 million, of which the undisbursed portion was $13.5 million. Of this $13.5 million, $7.9 million was associated with business lines of credit, $5.2 million was associated with home equity lines of credit, and $0.4 million was associated with consumer overdraft lines of credit. The Company's business lines of credit are generally extended for terms of one year, although the Company does provide two to three year line of credit facilities in certain cases based upon the customer's business need and available collateral. The Company's home equity lines of credit generally revolve for ten years, and then amortize over the following fifteen years. For additional information regarding the Company's loan commitments, please refer to Note 15 to the Consolidated Financial Statements.

Originations, Purchases, And Sales Of Loans. The Company's mortgage lending activities are conducted primarily through Bank employees in its eight full service branch offices and its Los Angeles loan production office (commencing in February 2002), and approximately 60 wholesale loan brokers who deliver completed loan applications to the Company. In addition, the Company has developed correspondent relationships with a number of financial institutions to facilitate the origination and sale of real estate loans on a participation basis. Loans presented to the Company for purchase or participation are generally underwritten substantially in accordance with the Company's established lending standards, which consider the financial condition and credit worthiness of the borrower, the location of the underlying property, and the cash flow and appraised value of the property, among other factors.

The Company plans to continue actively purchasing individual loans, loan pools, and loan participations in 2002 as a means of utilizing the Bank's strong regulatory capital position and supporting the more rapid transformation of the Company's balance sheet into that more consistent with a California community commercial bank. The Company anticipates that a majority of loan purchases and loan participations in 2002 will be associated with loans collateralized by income property.

Depending on its asset / liability strategy, the Company originates one to four family residential loans for sale in the secondary market. Loan sales are dependent on the level of loan originations and the relative customer demand for mortgage loans, which is affected by the current and expected future level of interest rates. During the years ended December 31, 2001 and 2000, the Company sold $11.5 million and $2.7 million, respectively, of longer term, fixed rate residential loans. The Company generally sells its fixed rate residential loans on a servicing released basis in order to take advantage of comparatively attractive servicing premiums being offered in the secondary market. While the level and timing of any future loan sales will depend upon market opportunities and prevailing interest rates, the Company anticipates selling the vast majority of its long term, fixed rate residential loan production in 2002 on a servicing released basis into the secondary market in conjunction with its asset / liability management program and in order to continue shifting its loan mix away from the historical concentration in residential mortgages.

From time to time, depending on its asset / liability and capital management strategies, the Company converts a portion of its mortgages into readily marketable mortgage backed securities, which can also be utilized in collateralized borrowings such as securities sold under agreements to repurchase. The Company's last such securitization occurred in 1998. Securitization is undertaken primarily to provide greater liquidity for the assets and thereby augment the Company's ability to manage its interest rate risk profile and cash flows. The Company may conduct future securitizations and / or the sale of hybrid or adjustable rate residential mortgages, depending upon its asset / liability and capital management strategies, in the future.

Loan Servicing. The Company services its own loans as well as loans owned by others. Loan servicing includes collecting and remitting loan payments, accounting for principal and interest, holding escrow funds for the payment of real estate taxes and insurance premiums, contacting delinquent borrowers, and supervising foreclosures and property dispositions in the event of unremedied defaults. Loan servicing income includes servicing fees from investors and certain charges collected from borrowers, such as late payment fees. At December 31, 2001, the Company was servicing $42.6 million of loans for others.

The Company's strategic plan does not contain a significant expansion in its loan servicing for others, as Management believes large volume residential loan servicers enjoy economies of scale and efficiencies in this business that render it difficult for the Company to compete and generate a desirable rate of return. The significant consolidation in the residential loan servicing industry that has occurred over the past several years, in the opinion of Management, supports this position.

Credit Quality

General. Although Management believes that non-performing loans are generally well secured and / or reserved, real estate acquired through foreclosure is properly valued, and inherent losses are provided for in the allowance for loan losses, there can be no assurance that future deterioration in local or national economic conditions, collateral values, borrowers' financial status, or other factors will not result in future credit losses and associated charges against operations. In regards to real estate acquired via foreclosure, although all such properties are actively marketed by the Company, no assurance can be provided regarding when these properties will be sold or what the terms of sale will be when they are sold. It is the Company's general policy to obtain appraisals at the time of foreclosure and to periodically obtain updated appraisals for foreclosed properties that remain unsold.

Non-accrual, Delinquent, And Restructured Loans. Management generally places loans on non-accrual status when they become 90 days past due, unless they are well secured and in the process of collection. Management also places loans on non-accrual status when they are less than 90 days delinquent when there is concern about the collection of the debt in accordance with the terms of the loan agreement. When a loan is placed on non-accrual status, any interest previously accrued but not collected is reversed from income. Loans are charged off when management determines that collection has become unlikely. Restructured loans are those where the Company has granted a concession on the interest paid, principal owed, or the original repayment terms due to financial difficulties of the borrower or because of issues with the collateral securing the loan.

Delinquent Loan Procedures. Specific delinquency procedures vary depending on the loan type and period of delinquency. However, the Company's policies generally provide that loans be reviewed at least monthly for delinquencies, and that if a borrower fails to make a required payment when due, the Company institutes internal collection procedures. For mortgage loans, written late charge notices are mailed no later than the 15th day of delinquency. At 25 days past due, the borrower is contacted by telephone and the Company makes a verbal request for payment. At 30 days past due, the Company begins tracking the loan as a delinquency, and at 45 days past due a notice of intent to foreclose is mailed. When contact is made with the borrower prior to foreclosure, the Company generally attempts to obtain full payment or develop a repayment schedule with the borrower to avoid foreclosure.

For business loans, the account relationship officer generally contacts the borrower within ten days of a delinquency. If the borrower is unable or unwilling to make contracted payments, the Company initiates collection efforts that vary by the type of business loan and the nature of the collateral. If the business loan is real estate secured, the Company follows collection procedures similar to those described above for mortgage loans. If the business loan is secured by inventory, equipment, or other non-real estate collateral, the Company pursues acquisition and liquidation of the pledged collateral. If the business loan has a personal guarantee, the Company will contact the guarantor to honor the guarantee and make the contractual loan payments. The Company may also proceed with various forms of legal action to enforce collection of delinquent business loans.

Non-performing Assets. Non-performing loans include non-accrual loans, loans 90 or more days past due and still accruing interest, and restructured loans. Non-performing assets include all non-performing loans, real estate acquired via foreclosure, and repossessed consumer assets.

Real estate acquired via foreclosure is recorded at the lower of the recorded investment in the loan or the fair value of the related asset on the date of foreclosure, less estimated costs to sell. Fair value is defined as the amount in cash or cash-equivalent value of other consideration that a real estate asset would yield in a current sale between a willing buyer and a willing seller. Development and improvement costs relating to the property are capitalized to the extent they are deemed to be recoverable upon disposal. The carrying value of acquired property is regularly evaluated and, if appropriate, an allowance is established to reduce the carrying value to fair value less estimated costs to sell. The Company typically obtains appraisals on real estate acquired through foreclosure at the time of foreclosure. The Company generally conducts inspections on foreclosed properties and properties deemed in-substance foreclosures on a quarterly basis.

The following table presents information regarding non-performing assets at the dates indicated.

	At	
	2001	2000
	(Dollar	
Outstanding Balances Before Valuation Reserves		
Non-accrual loans	$2,252	$4,666
Loans 90 or more days delinquent and accruing interest	--	--
Restructured loans in compliance with modified terms	--	75

Total gross non-performing loans	2,252	4,741
Investment in foreclosed real estate before valuation reserves	--	--
Repossessed consumer assets	--	--
Total gross non-performing assets	$2,252	$4,741
Gross non-performing loans to total loans	0.48%	1.19%
Gross non-performing assets to total assets	0.42%	0.98%
Allowance for loan losses	$6,665	$5,364
Allowance for loan losses / non-performing loans	295.96%	113.14%
Valuation allowances for foreclosed real estate	$ --	$ --

The decrease in non-accrual loans during 2001 was primarily due to the repayment in full of two comparatively large non-accrual loans in April 2001, one of which was a $2.85 million commercial construction loan for which the Company had established a $600 thousand specific reserve at December 31, 2000. This specific reserve was recaptured upon the collection in full of the associated loan.

The following table presents information concerning loans 60 to 89 days delinquent at the dates indicated.

	Loans On Accrual Status And Delinquent 60 - 89 Day			
	2001		2000	
(Dollars In Thousands)	Number Of Loans	Principal Balance	Number Of Loans	Principal Balance
Residential one to four unit	1	$ 154	4	$ 857
Other consumer loans	2	2	--	--
Total	3	$ 156	4	$ 857
60 - 89 day delinquent loans to gross loans net of undisbursed loan funds and unamortized yield adjustments		0.03%		0.22%

The following table presents information regarding non-accrual loans at the dates indicated.

	Loans On Non-accrual Status At Decembe	
	2001	2000
(Dollars In Thousands)	Number	Number

	Of Loans	Principal Balance	Of Loans	Principal Balance
Residential one to four unit	3	$ 1,372	2	$ 603
Commercial and industrial real estate	1	851	2	1,133
Commercial construction	--	--	1	2,852
Consumer lines of credit	1	1		
Business term loans	2	28	3	78
Business lines of credit	--	--	--	--
Total	7	$ 2,252	8	$ 4,666
Non-accrual loans to gross loans net of undisbursed loan funds and unamortized yield adjustments		0.48%		1.17%

Interest income foregone on non-accrual loans outstanding at year-end totaled $46 thousand, $110 thousand, and $109 thousand for the years ended December 31, 2001, 2000, and 1999, respectively. At December 31, 2001, the Company had no commitments to extend additional funds to loans on non-accrual status.

During early 2002, the Company was in the process of foreclosing upon the two of the three non-accrual residential mortgages in the above table. The borrower associated with the third non-accrual residential mortgage is a chronic delinquent. In addition, the borrower for the $851 thousand commercial real estate loan on non-accrual status at December 31, 2001 reinstated the loan in early 2002.

The following table presents information concerning restructured loans that were on accrual status at the dates indicated.

	Troubled Debt Restructured Loans On Accrual Status			
	2001		2000	
(Dollars In Thousands)	Number Of Loans	Principal Balance	Number Of Loans	Principal Balance
Residential one to four unit	--	$ --	1	$ 75
Total	--	$ --	1	$ 75
Weighted average interest rate		--		8.95%

Criticized And Classified Assets. To measure the quality of assets, the Company has established internal asset classification guidelines as part of its credit monitoring system for identifying and reporting current and potential problem assets. Under these guidelines, both asset specific and general portfolio valuation allowances are established.

The Company currently classifies problem and potential problem assets into one of four categories, presented below in order of increasing severity.

Category	Definition
Criticized Assets	
Special Mention	Special Mention loans (sometimes referred to as "watch list" loans) possess weaknesses, but do not currently expose the Company to sufficient risk to warrant categorization as a classified asset or assignment of a specific valuation allowance. Weaknesses that might categorize a loan as Special Mention include, but are not limited to, past delinquencies or a general decline in business, real estate, or economic conditions applicable to the loan.
Classified Assets	
Substandard	Substandard loans have one or more defined weakness and are characterized by the distinct possibility that the Company will sustain some loss if the deficiencies are not corrected.
Doubtful	Doubtful loans have the weaknesses of substandard loans, with the additional characteristic that the weaknesses make collection or liquidation in full on the basis of currently existing facts, conditions, and values questionable; and there is a high possibility of loss of some portion of the principal balance.
Loss	Loss loans are considered uncollectible and their continuance as an asset is not warranted.

The Company's methodology for calculating the allowance for loan losses includes higher formula allowance factors for criticized and classified loans than for loans not adversely graded ("Pass loans"). The formula allowance factor for a given type of loan (e.g. commercial & industrial real estate loans) is progressively higher for loans graded Special Mention, Substandard, and Doubtful. These amounts represent loss allowances which have been established to recognize the inherent risk associated with these lending activities, but which, unlike specific allowances, have not been allocated to particular problem assets. Judgments regarding the adequacy of valuation allowances are based on continual evaluation of the nature, volume and quality of the loan portfolio, collateral assets, borrower financial status, and current economic conditions that may affect the recoverability of recorded amounts. Assets classified as a loss require either a specific valuation allowance equal to 100% of the amount classified or a charge-off of such amount.

The following table presents the Company's criticized and classified assets at the dates indicated:

Outstanding Balances Before Specific Valuation Allowances	2001
Criticized Assets	
Special mention	$ 6,207
Classified Assets	
Substandard loans	$ 5,098
Real estate acquired via foreclosure	--
Total classified assets	$ 5,098
Classified assets to total loans plus other real estate owned (1)	1.08%
Classified assets to total assets	0.95%
Classified assets to shareholders' equity	10.16%
Allowance for loan losses to total classified assets	130.74%

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(1) Total loans equals total gross loans less undisbursed loan funds and (less) or plus unamortized yield adjustments. Other real estate owned is included on a gross basis before any valuation allowances.

Substandard assets at December 31, 2001 included a $2.3 million "mini-perm" mortgage loan participation maturing in 2004 secured by a beach resort in the Company's primary business area. The resort has experienced lower occupancy than forecast, contributing to a reduced cash flow and inadequate debt service coverage. The borrowers have been thirty to sixty days delinquent during late 2001 and early 2002. In early 2002, the Company learned that a sale of some or all of the subject property was being pursued. The Company cannot, however, predict whether the property will be sold and at what price. The loan agreement contains a due on sale clause that the Company intends to enforce in the event of a sale.

Substandard loans at December 31, 2001 also included an $851 thousand commercial real estate loan in the Company's primary market area that was reinstated in early 2002, and an $845 thousand residential mortgage secured by a home in the East Bay section of the San Francisco Bay Area.

Special Mention loans at December 31, 2001 included two multifamily loans with an aggregate principal balance of $2.7 million and three commercial real estate loans with an aggregate balance of $2.5 million, including one motel loan with a principal balance of $1.3 million. These three commercial real estate loans were all secured by real properties in the Company's primary market area.

A savings institution's determination as to the classification of its assets and the amount of its valuation allowances is subject to review by the OTS, which can require the establishment of additional general or specific loss allowances. The OTS, in conjunction with the other federal banking agencies, has adopted an interagency policy statement on allowances for loan and lease losses that provides guidance in determining the adequacy of general valuation guidelines. The policy statement recommends that savings institutions establish effective systems and controls to identify, monitor, and address asset quality problems, analyze significant factors that affect the collectibility of assets, and establish prudent allowance evaluation processes. Management believes that the Company's allowance for loan losses is adequate given the composition and risks of the loan portfolio. However, actual losses are dependent upon future events and, as such, further additions to the level of specific and general loan loss allowances may become necessary. In addition, there can be no assurance that at some time in the future the OTS, in reviewing the Company's loan portfolio, will not request the Company to increase its allowance for loan losses, thus negatively impacting the Company's results of operations for that time period.

Impaired Loans. The Company defines a loan as impaired when it meets one or more of the following criteria:

- It is probable that the Company will be unable to collect all contractual principal and interest in accordance with the original terms of the loan agreement.

- The loan is ninety or more days past due.

- The loan is placed on non-accrual status although less than ninety days past due.

- A specific valuation reserve has been allocated against the loan.

- The loan meets the criteria for a troubled debt restructuring.

The policy of the Company is to review each loan in the portfolio to identify problem credits. The nature of this review varies by the type of loan and its underlying collateral. For example, most residential mortgages are evaluated for impairment following a delinquency, while the Company conducts credit analysis on each income property loan exceeding certain thresholds at least annually regardless of payment performance. In reviewing each loan, the Company evaluates both the amount the Company believes is probable that it will collect and the timing of such collection. As part of the loan review process, the Company considers such factors as the ability of the borrower to continue meeting the debt service requirements, assessments of other sources of repayment, and the fair value of any collateral. Insignificant delays or shortfalls in payment amounts, in the absence of other facts and circumstances, would not alone lead to the conclusion that a loan is impaired.

Each loan identified as impaired is evaluated for the need for a specific loss reserve. The adequacy of these specific loss reserves is reviewed regularly, and no less frequently than quarterly. A loan's specific loss reserve is calculated by comparing the Company's net investment in the loan to one or more of the following, as applicable to the nature of the loan:

- the present value of the loan's expected future cash flows discounted at the loan's effective interest rate at the date of initial impairment

- the loan's observable market price

o the fair value of the collateral securing the loan

The Company charges off a portion of an impaired loan against the specific valuation allowance when it is probable that a part of the loan will not be recoverable.

At December 31, 2001, the Company had impaired loans totaling $2.3 million, which had no related specific reserves. At December 31, 2000, the Company had impaired loans of $5.3 million, with related specific reserves of $600 thousand. Additional information concerning impaired loans is presented below and in Note 5 to the Consolidated Financial Statements.

	2001	2000
		(Dollars In
Average investment in impaired loans for the year	$ 2,304	$ 7,790
Interest recognized on impaired loans at December 31	$ 146	$ 461
Interest not recognized on impaired loans at December 31	$ 46	$ 110

The decrease in the average investment in impaired loans in 2001 versus 2000 primarily resulted from a $5.0 million business term loan originated by MBBC that was identified as impaired in the fourth quarter of 1999 and paid off in full in December, 2000.

Other than those loans already categorized as non-performing or classified at December 31, 2001, the Company has not identified any other potential problem loans, which would result in those loans being included as non-performing or classified loans at a future date, with the exception of two business term loans totaling $371 thousand extended to corporate entities associated with an individual that declared bankruptcy in the first quarter of 2002. In addition, in early 2002, the Company became aware of the transfer of title of a motel serving as collateral for a $2.4 million commercial real estate loan, in violation of the Company's due on sale clause in its loan documents. The motel is in the Company's primary market area. The Company was successful in collecting in full on this loan in the first quarter of 2002.

The Company had no loans outstanding to foreign entities at December 31, 2001.

Special Residential Loan Pool. During 1998, the Bank purchased a $40.0 million residential mortgage pool comprised of loans secured by homes throughout the nation (but with a concentration in California) that presented a borrower credit profile and / or a loan to value ratio outside of (less favorable than) the Bank's normal underwriting criteria. To mitigate its credit risk for this portfolio, the Bank obtained at purchase a scheduled principal / scheduled interest loan servicing agreement from the seller. Further, this agreement also contains a guaranty by the seller to absorb any principal losses on the portfolio in exchange for the seller's retention of a portion of the loans' yield through loan servicing fees. In obtaining these credit enhancements, the Bank functionally aggregated the credit risk for this loan pool into a single borrower credit risk to the seller / servicer of the loans. The Bank was subsequently informed by the OTS that structuring the purchase in this manner made the transaction an "extension of credit" by the Bank to the seller / servicer, which, by virtue of its size, violated the OTS' "Loans To One Borrower" regulation. See "Regulation And Supervision - Loans To One Borrower Limitation" and Note 14 to the Consolidated Financial Statements. The Bank continues to report to the OTS in this regard on a monthly basis.

At December 31, 2001, the outstanding principal balance of the Special Residential Loan Pool was $5.6 million. In comparison, the outstanding principal balance of the Special Residential Loan Pool was $16.5 million at December 31, 2000. Following the February 20, 2002 regular monthly remittance, the outstanding balance of the Special Residential Loan Pool declined to $4.75 million. All of the loans within the Special Residential Loan Pool are adjustable rate mortgages.

While the seller / servicer met all its contractual obligations through the February 20, 2002 regularly scheduled reporting and remittance date, the Company has allocated certain loan loss reserves due to concerns regarding the potential losses by the seller / servicer in honoring the guaranty, the present delinquency profile of the Special Residential Loan Pool, and the differential between loan principal balances and current appraisals for foreclosed loans and loans in the process of foreclosure.

Because the seller / servicer provides scheduled principal and interest payments regardless of the actual payment performance of the loans and because the seller / servicer is required to absorb all losses on the disposition of associated foreclosed real estate, the Company reports all loans within the Special Residential Loan Pool as performing.

At December 31, 2001, the Special Residential Loan Pool was comprised of 52 residential mortgages, the largest of which had a principal balance of $278 thousand. The homes securing the Special Residential Loan Pool at December 31, 2001 were concentrated in California, followed by Utah, Oregon, and Michigan. The weighted average gross interest rate on the Special Residential Loan Pool at December 31, 2001 was 9.95%. The differential between the interest rates on the loans and available refinance rates contributed to the significant prepayments during 2001.

At December 31, 2001, the Special Residential Loan Pool included four loans where the underlying collateral had been foreclosed. The aggregate principal balance of these four loans was $392 thousand, with the largest such loan having a principal balance of $115 thousand.

Management believes additional prepayments are likely to occur in 2002. However, management also believes that there will be some loans that will not refinance in the next year due to a lack of available financing for less creditworthy borrowers or because of borrower inaction. In 2002, the Company may therefore be particularly dependent upon the financial strength and continued performance of the seller / servicer, as the remaining portfolio is expected to be comprised of relatively less creditworthy loans while at the same time having a smaller remaining total principal balance and thereby providing less periodic cash flow to the seller / servicer via the retained servicing spread.

The Company monitors the financial performance and condition of the seller / servicer on a monthly basis. The earnings and capital of the seller / servicer experienced favorable results during 2001, supported by the strong mortgage refinance market. In addition, the Company regularly analyzes the payment performance and credit profile of the remaining outstanding loans.

In conjunction with this Special Residential Loan Pool, during the first quarter of 2000, the Bank received a letter from the OTS mandating that:

1. all loans associated with the Special Residential Loan Pool would be required to be assigned to the 100% risk based capital category in calculating regulatory capital ratios that incorporate risk weighted assets

2. the Bank's regulatory capital position at December 31, 1999 and thereafter must reflect the above requirement

3. until further notice, the Bank's regulatory capital ratios were required to be maintained at levels no lower than the levels at December 31, 1999

The Bank continually complied with the above requirements through December 31, 2001. In early 2002, the Bank received a letter from the OTS notifying the Bank that the institution specific regulatory capital requirements imposed in early 2000, as described above in point number three, were eliminated.

Allowance For Loan Losses. The allowance for loan losses is established through a provision for loan losses based on Management's evaluation of the risks inherent in the Company's loan portfolio, including unused commitments to provide financing. The allowance for loan losses is increased by provisions charged against earnings and reduced by net loan charge-offs. Loans are charged-off when they are deemed to be uncollectible; recoveries are generally recorded only when cash payments are received.

The allowance for loan losses is maintained at an amount management considers adequate to cover losses in loans receivable that are deemed probable and estimable. The allowance is based upon a number of factors, including, but not limited to, asset classifications, the size and mix of the loan portfolio, economic trends and conditions, industry experience and trends, industry and geographic concentrations, estimated collateral values, management's assessment of the credit risk inherent in the portfolio, historical loan loss experience, changes in non-performing and past due loans, and the Company's underwriting policies. While Management uses the best information available to make these estimates, future adjustments to allowances may be necessary due to economic, operating, regulatory, and other conditions that may be beyond the Company's control or ability to foresee.

The allowance for loan losses is comprised of three primary types of allowances:

1. Formula Allowance

Formula allowances are based upon loan loss factors that reflect management's estimate of the inherent loss in various segments of or pools within the loan portfolio. The loss factor is multiplied by the portfolio segment (e.g. multifamily permanent mortgages) balance (or credit commitment, as applicable) to derive the formula allowance amount. The loss factors are updated periodically by the Company to reflect current information that has an effect on the amount of loss inherent in each segment. The formula allowance at December 31, 2001 was $6.0 million, compared to $4.0 million at December 31, 2000.

2. Specific Allowance

Specific allowances are established in cases where management has identified significant conditions or circumstances related to an individually impaired credit. In other words, these allowances are specific to the loss inherent in a particular loan. The amount for a specific allowance is calculated in accordance with SFAS No. 114, "Accounting By Creditors For Impairment Of A Loan". The Company had no specific allowance at December 31, 2001 and had $600 thousand in specific allowance at December 31, 2000.

3. Unallocated Allowance

The Company maintains an unallocated loan loss allowance that is based upon management's evaluation of conditions that are not directly measured in the determination of the formula and specific allowances. The evaluation of inherent loss with respect to these conditions is subject to a higher degree of uncertainty because they are not identified with specific problem credits or historical performance of loan portfolio segments. At December 31, 2001, the Company had $668 thousand in unallocated allowance, compared to $739 thousand at December 31, 2000. The conditions evaluated in connection with the unallocated allowance at December 31, 2001 included the following, which existed at the balance sheet date:

- General business and economic conditions affecting the Company's key lending areas
- Real estate values in California
- Loan volumes and concentrations
- Seasoning of the loan portfolio
- Status of the current business cycle
- Specific industry or market conditions within portfolio segments

In addition to the requirements of Accounting Principles Generally Accepted in the United States of America, or "GAAP", related to loss contingencies, a federally chartered savings association's determination as to the classification of its assets and the amount of its valuation allowances is subject to review by the OTS. The OTS, in conjunction with other federal banking agencies, provides guidance for financial institutions on both the responsibilities of management for the assessment and establishment of adequate allowances and guidance for banking agency examiners to use in determining the adequacy of general valuation allowances. It is required that all institutions:

- have effective systems and controls to identify, monitor, and address asset quality problems
- analyze all significant factors that affect the collectibility of the loan portfolio in a reasonable manner
- establish acceptable allowance evaluation processes that meet the objectives of the federal regulatory agencies

Various regulatory agencies, in particular the OTS, as an integral part of their examination process, periodically review the Company's allowance for loan losses. These agencies may require the Company to make additional provisions for loan losses, based on their judgments of the information available at the time of the examination. Although Management believes that the allowance for loan losses is adequate to provide for estimated inherent losses in the loan portfolio, future provisions charged against operations will be subject to continuing evaluations of the inherent risk in the loan portfolio. In addition, if the national or local economy declines or asset quality deteriorates, additional provisions could be required. Such additional provisions could negatively and materially impact the Company's financial condition and results of operations.

The following table presents information concerning the Company's allowance for loan losses at the dates and for the years indicated.

(Dollars In Thousands)	2001	2000	1999
Period end loans outstanding (1)	$ 473,265	$ 397,184	$ 364,188
Average loans outstanding (2)	432,020	379,823	339,036
Period end non-performing loans outstanding	2,252	4,741	8,182
Allowance for loan losses			
Balance, at beginning of year	$ 5,364	$ 3,502	$ 2,780
Charge-offs:			
Residential one to four unit real estate loans	--	(371)	(113)
Other consumer loans	(4)	--	--
Business lines of credit	(95)	--	--
Total charge-offs	(99)	(371)	(113)
Recoveries:			
Residential one to four unit real estate loans	--	58	--
Total recoveries	--	58	--
Net (charge-offs) recoveries	(99)	(313)	(113)
Provision charged to operations	1,400	2,175	835
Allowance acquired in conjunction with loan purchase	--	--	--
Balance, at end of year	$ 6,665	$ 5,364	$ 3,502
Net charge-offs (recoveries) to average loans outstanding (2)	0.02%	0.08%	0.03%
Allowance as a percent of year end loans outstanding (1)	1.41%	1.35%	0.96%
Allowance as a percent of non-performing loans	295.96%	113.14%	42.80%

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(1) net of undisbursed loan funds, unamortized purchase premiums net of purchase discounts, and deferred loan fees and costs, net

(2) net of undisbursed loan funds, unamortized purchase premiums net of purchase discounts, deferred loan fees and costs, net, and allowances for loan losses

The charge-offs recorded by the Company in 2001 for business lines of credit all stemmed from the Business Express program, which was terminated in 2001. The Business Express program targeted small and / or relatively new local businesses with lines of credit up to $25,000. These businesses were impacted by the recession in the second half of 2001, as they did not generally have the financial strength and number of years of operation that permit businesses to weather less robust economic environments.

The following table provides a summary of the allocation of the allowance for loan losses for specific loan categories at the dates indicated. The allocation presented should not be interpreted as an indication that charges to the allowance for loan losses will be incurred in these amounts or proportions, or that the portion of the allowance allocated to each loan category represents the total amounts available for future losses that may occur within these categories. The unallocated portion of the allowance and the total allowance is applicable to the entire loan portfolio.

	At December 31,						
	2001		2000		1999		
(Dollars In Thousands)	Amount	% Of Loans In Category To Gross Loans(1)	Amount	% Of Loans In Category To Gross Loans(1)	Amount	% Of Loans In Category To Gross Loans(1)	Amou
Residential	$ 1,710	42.2%	$ 1,143	37.8%	$ 663	43.4%	$
Multifamily	713	21.4%	470	18.1%	185	10.9%	
Commercial real estate	2,374	22.7%	1,232	24.1%	918	18.6%	
Construction	525	7.9%	1,164	13.9%	960	20.3%	
Land	336	2.5%	400	3.9%	137	3.6%	
Home equity lines of credit	30	1.4%	32	1.3%	32	1.0%	
Other consumer loans	11	0.1%	11	0.2%	15	0.2%	
Business term loans	111	0.6%	148	0.4%	243	1.7%	
Business lines of credit	187	1.2%	25	0.3%	83	0.3%	
Total allocated	5,997	100.0%	4,625	100.0%	3,236	100.0%	2,
Unallocated	668		739		266		
Total	$ 6,665		$ 5,364		$ 3,502		$ 2,
Other information							
Gross loans outstanding held for investment	$484,940		$423,945		$388,198		$327,

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(1) Gross loans held for investment

Over the past several years, the Company has increased its allowance for loan losses in conjunction with three key trends within the loan portfolio:

- The growth in the nominal size of the loan portfolio has led Management to increase the amount of the allowance.

- The greater diversification in the mix of the loan portfolio away from residential one to four unit permanent mortgages toward other types of lending, particularly income property loans, has led to higher nominal and relative allowance levels, as these newer types of lending typically present more risk than residential mortgages. This increased risk stems both from the nature of the lending and the greater individual credit amounts associated with income property loans.

- The increasing concentration of the portfolio in relatively less seasoned credits, because of the Company's growth rate in recent years, has also led Management to increase the level of the allowance, as less seasoned loans typically present greater risk than loans which have been performing for many years.

The Company's loan portfolio at December 31, 2001 presented significant geographic concentration, consistent with the Company's focus of serving local individuals and businesses as a community commercial bank. The majority of the Company's loans outstanding at December 31, 2001 were secured by real estate located in the three counties that constitute the Company's primary market area:

- Santa Cruz County
- Monterey County
- Santa Clara County

This concentration provides certain benefits. For example, the Company becomes well known in its local area and therefore attracts more business. In addition, Management develops a more comprehensive knowledge of real estate values and business trends in markets where lending is regularly conducted. However, this concentration also presents certain risks. A natural disaster such as an earthquake centered in the Greater Monterey Bay Area would impact the Company more significantly than firms with loans geographically dispersed over a wider area. Another concentration risk is that a downturn in the economy or real estate values in the Greater Monterey Bay Area would disproportionately unfavorably impact the Company versus a State-wide or national lender. The geographic concentration of the Company's loans is an important factor that Management considers in determining appropriate levels of loan loss reserves.

At December 31, 2001, the Company had outstanding less than $5.0 million in loans outside the State of California, with a majority of such loans associated with the Special Residential Loan Pool (see Note 14 to the Consolidated Financial Statements). The Company's strategic plan does not include substantial lending in 2002 outside the State of California. The Company does, however, intend to pursue the purchase of loans, particularly income property loans, throughout much of California during 2002, in addition to directly originating income property and construction loans through the new Los Angeles loan production office. Over time, the Company intends to reduce its real estate loan concentration in the three counties comprising its primary market area, somewhat offset by increased extensions of credit to businesses domiciled in the three counties.

During 2001, among the changes implemented to the Company's loan loss reserve methodology were increases in the formula allowances for real estate loans secured by hotels / motels and for the Business Express portfolio. General allowance levels were increased for hotel / motel loans due to the increase in vacancies and reduction in average room rates caused by the national recession and the reduced volume of travel after the events of September 11, 2001. Loan reviews during late 2000 for hotel / motel loans and third party reports suggested a systemic reduction in net cash flows for the hospitality industry. Increased charge-off experience and the onset of the national recession led management to increase the formula allowance for Business Express loans during 2001. At December 31, 2001, the Company had $30.8 million in real estate loans outstanding secured by hotel / motel properties and $543 thousand of Business Express loans outstanding.

During the first quarter of 2002, the Company intends to undertake a special credit review of its hotel / motel portfolio in order to identify borrowers that might be particularly adversely impacted by events and trends in that industry.

The $668 thousand in unallocated allowance at December 31, 2001 reflected the Company's consideration of the following factors, as well as more general factors including the national recession, increased layoffs and unemployment, the weak equity markets, a significant California State budget deficit, and consumer and business reactions to the events of September 11, 2001:

- The adverse effects of a decline in tourism impacting the local economies in Santa Cruz and Monterey counties, with a concomitant impact upon net cash flows for local commercial enterprises, commercial real estate properties, and owner / operators of small businesses, which could be in the range of $100 thousand to $400 thousand.

- The adverse impacts of the weakening technology industry upon commercial real estate values. The Company's primary lending area is near the Silicon Valley area of the San Francisco Bay Area, which has been impacted by the slump in various technology and technology related businesses. This impact could be in the range of $100 thousand to $800 thousand.

As subsequently discussed (see "Provision For Loan Losses"), the lower provision for loan losses recorded during 2001 versus 2000 resulted from multiple factors, including lower net charge-offs and the recapture of a $600 thousand specific reserve during the second quarter of 2001.

Management anticipates that should the Company accomplish its strategic plan and be successful in:

- generating further growth in loans receivable held for investment,
- emphasizing the origination and purchase of income property real estate loans,
- continuing expansion of commercial business lending, and
- reducing the portfolio concentration in relatively lower risk residential mortgages,

future provisions will result and the ratio of the allowance for loan losses to loans outstanding will increase in a manner consistent with the Company's loan loss allowance methodology. Experience across the financial services industry indicates that commercial business and income property loans present greater risks than residential real estate loans, and therefore should be accompanied by suitably higher levels of reserves.

Investment Activities

Cash Equivalents. The Company does not include certain short term, highly liquid investments as investment securities, instead classifying these as cash equivalents. These include:

- federal funds sold
- securities purchased under agreements to resell
- commercial paper
- money market mutual fund investments
- banker's acceptances
- certificates of deposit in federally insured financial institutions

Liquidity Maintenance. Federally chartered savings institutions have the authority to invest in various types of liquid assets, as defined in applicable regulations, including United States Treasury obligations, securities of or guaranteed by various federal agencies, certificates of deposit of insured banks and savings institutions, bankers' acceptances, repurchase agreements, and federal funds. Additionally, under OTS regulations, the Bank must maintain a safe and sound level of liquidity at all times. Management agrees that maintaining an adequate level of liquidity at all times is fundamental to effective guidance of a financial institution. Management believes that the Bank at all times in 2001 maintained a level of available liquidity considered to be adequate to meet foreseeable operational needs.

Investment Policies. In addition to the above liquid assets, subject to various restrictions, federally chartered savings institutions may also invest in various other types of securities, including investment-grade corporate debt securities, asset-backed securities, collateralized mortgage obligations not guaranteed by a federal agency, and mutual funds whose assets conform to the investments that a federally chartered savings institution is otherwise authorized to make directly. The Company maintains separate internal investment policies for the Bank and MBBC. These policies are established by the Board of Directors with the key objectives of:

- providing and maintaining liquidity
- generating a favorable total return on a risk-adjusted basis
- managing the overall interest rate risk profile of the entities
- maintaining compliance with various associated regulations
- controlling credit risk exposure

Specifically, the Company's policies generally limit investments to publicly traded securities that are investment grade. These policies prohibit the Company's maintenance of a trading portfolio as defined under SFAS No. 115.

Accounting And Reporting. Investment securities classified as available for sale are recorded at fair value, while investment securities classified as held to maturity are recorded at cost. Unrealized gains or losses on available for sale securities, net of the deferred tax effect, are reported as a component of other comprehensive income and are included in stockholders' equity.

The amortized cost and estimated fair value of securities are presented in the following tables. "PT" represents "pass-through" and "CMO" represents "collateralized mortgage obligation".

(Dollars In Thousands) Available for sale	December 31, 2001 Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses
Variable rate corporate trust preferred securities	$ 7,707	$ --	$ (407)
Fixed rate FHLMC PT's	1,551	34	--
Fixed rate FNMA PT's	585	38	--
Fixed rate GNMA PT's	744	31	--
Variable rate FNMA PT's	4,629	62	--
Fixed rate FHLMC balloons	1,956	--	--
Fixed rate CMO's:			
Agency issuance	17,062	86	--
Non Agency issuance	3,831	35	--
	$38,065	$ 286	$ (407)

(Dollars In Thousands) Available for sale	December 31, 2000 Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses
Variable rate corporate trust preferred securities	$ 7,696	$ --	$ (336)
Fixed rate FHLMC PT's	1,090	13	--
Fixed rate FNMA PT's	3,649	25	(2)
Fixed rate GNMA PT's	1,060	--	(11)
Variable rate FNMA PT's	571	5	--
Fixed rate CMOs:			
Agency issuance	19,095	5	(266)
Non Agency issuance	18,210	4	(498)
	$51,371	$ 52	$(1,113)

(Dollars In Thousands) Available for sale	December 31, 1999 Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses
Variable rate corporate trust preferred securities	$11,456	$ 50	$ (43)
Fixed rate FHLMC PT's	1,930	--	(36)
Fixed rate FNMA PT's	24,371	95	(375)
Fixed rate GNMA PT's	4,531	--	(96)
Variable rate FNMA PT's	761	--	(4)
Fixed rate CMO's:			
Agency issuance	11,152	--	(974)

Non Agency issuance	16,965	--	(604)
	$71,166	$ 145	$(2,132)
Held to maturity			
Fixed rate FNMA balloons	$ 60	$ --	$ --

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At December 31, 2001, the Company's investment in corporate trust preferred securities was entirely composed of variable rate securities which reprice every three months based upon a margin over the three month LIBOR rate. These corporate trust preferred securities were all rated "A-" or better by Standard & Poors ratings agency at December 31, 2001.

Over the past two years, the Company has restructured its security portfolio in pursuing the following objectives:

- generating a steady stream of cash flows to provide liquidity in support of the expanding loan portfolio
- increasing the interest rate sensitivity of the portfolio in conjunction with the Company's asset / liability management program
- maintaining sufficient US Agency CMO's to provide collateral for various types of secured deposits, primarily funds placed with the Bank by the State of California under its time deposit program
- increasing the investment in CMO's versus PT's in order to better tailor the portfolio's cash flows to the projected liquidity needs of the Company
- classifying all securities as available for sale in order to provide additional flexibility in balance sheet management
- reducing the size of the security portfolio relative to total assets in order to allocate a greater percentage of the balance sheet to loans in conformity with the Company's strategic plan

The following table presents certain information regarding the amortized cost, estimated fair value, weighted average yields, and contractual maturities of the Company's securities as of December 31, 2001. Actual maturities may differ from contractual maturities due to principal prepayments, priority of principal allocation within collateralized mortgage obligations, or rights of issuers to call obligations prior to maturity.

	At December 31, 2001			
(Dollars In Thousands)		2003 Through	2007 Through	
Available for sale securities	2002	2006	2011	Therea
Variable rate corporate trust				

preferred securities	$ --	$ --	$ --	$ 7
Fixed rate FHLMC PT's	--	--	--	1
Fixed rate FNMA PT's	--	--	--	
Fixed rate GNMA PT's	--	--	601	
Variable rate FNMA PT's	--	--	--	4
Fixed rate FHLMC balloons	--	--	1,956	
Fixed rate CMO's:				
Agency issuance	--	900	--	16
Non Agency issuance	--	--	--	3
Total amortized cost	$ --	$ 900	$ 2,557	$ 34
Estimated fair value	$ --	$ 907	$ 2,582	$ 34
Weighted average yield (1)	--	5.90%	5.28%	4

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(1) Weighted average yield is calculated based upon estimated fair value.

The Company maintained no tax-preferenced securities at December 31, 2001. At December 31, 2001, the Company did not own debt securities issued by any one issuer other than US Agencies that exceeded ten percent of stockholders' equity. For additional information regarding the Company's securities, please refer to Notes 3 and 4 to the Consolidated Financial Statements.

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Sources Of Funds

General. The Company's primary sources of funds are customer deposits, principal, interest, and dividend payments on loans and securities, FHLB advances and other borrowings, and, to a lesser extent, proceeds from sales of securities and loans. While maturities and scheduled amortization of loans and securities are predictable sources of funds, deposit flows and loan and security prepayments are greatly influenced by general interest rates, economic conditions, and competition.

Deposits. The Company offers a variety of deposit accounts with a range of interest rates, features, and terms. The Company's deposits consist of demand deposit and NOW checking accounts, savings accounts, money market accounts, and certificates of deposit. The flow of deposits is influenced significantly by general economic conditions, events in the capital markets, money supply, prevailing interest rates, and competition. The Company's deposits are obtained predominantly from the areas in which its full service branch offices are located. The Company relies primarily on customer service and long standing relationships with customers to attract and retain these deposits; however, market interest rates and rates offered by competing financial institutions and mutual funds significantly affect the Company's ability to attract and retain deposits. While the Bank is currently eligible to accept brokered deposits, it has not done so. The Bank participates in the State of California Time Deposit Program, whereby the State places certificates of deposit with banks as a means of encouraging lending back into California's communities. Management regularly monitors the Company's certificate accounts and historically the Company has retained a large portion of such accounts upon maturity.

The Company's strategic plan incorporates increasing the percentage of deposits represented by transaction accounts. Management believes that transaction accounts present the opportunity to strengthen customer relationships, build franchise value, generate fee income, and lower the Company's relative cost of funds. In addition, an expansion in transaction accounts supports the Company's asset / liability management program, as transaction accounts are generally less interest rate sensitive than most alternative sources of funding.

In recent years, the Company has offered a series of money market deposit accounts specifically designed for certain target markets. Customers wishing to avoid account maintenance fees and maintain low minimum balances are marketed the Company's Easy Access money market account. Customers planning to maintain particularly high average balances are marketed the Company's highly tiered and more aggressively priced Money Market Plus account. Customers in between these two profiles are marketed the competitively priced Lighthouse money market account. All three of these money market products offer check writing, 24 hour bilingual telephone banking, Internet banking, ATM access, bank by mail, and in-branch service. As a result of this target marketing, money market deposit balances have increased in recent years, from $81.2 million at December 31, 1999 to $87.7 million at December 31, 2000 to $105.8 million at December 31, 2001. Expansion in money market balances during 2001 benefited from the interest rate environment, as certain customers were less interested in committing to term certificates of deposit with interest rates at historically low levels.

The Company's other area of focus in deposit acquisition in recent years has been checking accounts, coincident with the Company's business strategy of becoming more of a community based financial services organization, meeting the primary financial needs of both consumers and small businesses. Total checking balances expanded from $58.9 million at December 31, 2000 to $63.6 million at December 31, 2001. In addition, checking accounts expanded 13.3% of total deposits at December 31, 1999 to 14.4% at December 31, 2000 to 14.7% at December 31, 2001.

The rise in checking account balances during 2001 was supported by increased checking account balances maintained by local businesses with which the Company established comprehensive relationships in 2001, including such services as lines of credit, courier service, real estate financing, and dedicated account relationship officers. The Company plans to further augment its business checking product line in 2002 with the introduction of Internet banking for businesses.

The Company also plans to augment its line of consumer checking products in 2002, with improved customer statements and continued marketing of Internet banking for consumers, including electronic bill payment. Consumer checking promotions for 2002 are planned for the Company's Interest Checking Plus product, which provides relatively higher, tiered interest rates for those consumers who maintain more substantial balances in their checking accounts.

At December 31, 2001, all of the Company's deposit products were statement based (i.e. no passbooks). Management believes that statement based products integrate more effectively with the increasingly numerous and varied means of customer electronic access to their funds; e.g. Internet banking, electronic bill payment, debit / point of sale, ATM networks, and telephone banking.

During 2001, the Company's certificate of deposit portfolio decreased by $945 thousand despite a $5.0 million increase in funds from the State of California Time Deposit Program. A portion of the decrease in certificate of deposit balances during 2001 was associated with customer transfers of funds into money market accounts due to the historically low interest rate environment. During the past several years, the Company has focused its deposit related sales efforts on transaction accounts as a means of increasing net interest margins, bolstering fee income, and building more comprehensive customer relationships. In addition, during 2001, the Company encountered significant price competition for certificates of deposit from two very large thrifts in particular, and from new or Internet banks seeking to build their customer bases through aggressive pricing without regard to short term profitability.

The Company's weighted average cost of deposits at December 31, 2001 was 2.87%, equal to 20 basis points below the 11th District Cost Of Funds Index ("COFI") for December 2001 of 3.07%. While COFI contains funding components other than deposits, the Company uses a comparison to COFI as a benchmark of its success in managing its cost of deposits. The Company seeks to manage its cost of deposits both via pricing for individual products and through the deposit portfolio product mix.

The Company maintained no deposits in foreign banking offices at December 31, 2001 or December 31, 2000.

The Company's weighted average cost of deposits decreased significantly in 2001 primarily due to the 11 interest rate cuts totaling 475 basis points implemented by the Federal Reserve, and to a lesser extent because of a shift in deposit mix. The following table summarizes the Company's deposits at the dates indicated.

(Dollars In Thousands)	December 31, 2001 Balance	December 31, 2001 Weighted Average Rate	Decem Balance
Demand deposit accounts	$ 21,062	--	$ 17,065
NOW accounts	42,557	0.41%	41,859
Savings accounts	19,127	0.57%	16,503
Money market accounts	105,828	2.31%	87,651
Certificates of deposit <$100,000	156,351	4.02%	166,905
Certificates of deposit $100,000 or more	87,414	3.86%	77,805
	$432,339		$407,788
Weighted average nominal interest rate		2.87%	

The weighted average interest rates are at the end of the period and are based upon stated interest rates without giving consideration to daily compounding of interest or forfeiture of interest because of premature withdrawal.

The following table presents the amount and weighted average rate of time deposits equal to or greater than $100,000 at December 31, 2001. The amount maturing in three months or less includes $16.1 million associated with the State of California Time Deposit Program.

(Dollars In Thousands) Maturity Period	At December 3 Amount
Three months or less	$ 36,273
Over three through 6 months	15,944
Over 6 through 12 months	18,100
Over 12 months	17,097
Total	$ 87,414

The following table presents the amount and weighted average rate of time deposits less than $100,000 at December 31, 2001.

(Dollars In Thousands) Maturity Period	At December 3 Amount
Three months or less	$ 44,749
Over three through 6 months	37,684
Over 6 through 12 months	40,313
Over 12 months	33,605
Total	$ 156,351

The following table presents the distribution of the Company's average balances of deposit accounts for the periods indicated and the weighted average interest rates on each category of deposits presented.

	For The Year Ended December 31,						
	2001			2000			
	Average Balance	% Of Average Total Deposits	Weighted Average Rate	Average Balance	% Of Average Total Deposits	Weighted Average Rate	Averag Balanc
	(Dollars In Thousands)						
Demand deposits	$ 19,104	4.6%	--	$ 16,719	4.3%	--	$ 17,61
NOW accounts	40,944	9.8%	0.89%	36,317	9.4%	1.51%	25,20
Savings accounts	19,370	4.6%	1.12%	15,803	4.1%	1.78%	15,58
Money market accounts	92,237	22.1%	3.74%	87,733	22.7%	4.60%	82,00
Certificates of deposit	246,315	58.9%	5.04%	230,099	59.5%	5.37%	229,49

Total	$417,970	100.0%	3.93%	$386,671	100.0%	4.45%	$369,89

Please refer to Note 10 to the Consolidated Financial Statements for additional information concerning deposits.

Borrowings

From time to time, the Company obtains borrowed funds through FHLB advances, federal funds purchased, MBBC's line of credit, and securities sold under agreements to repurchase. Borrowings are used to supplement deposits as a source of funding. Borrowings are also used as a tool in the Company interest rate risk management process.

FHLB advances are collateralized by the Bank's pledged mortgage loans, pledged mortgage backed securities, and investment in the capital stock of the FHLB. See "Regulation And Supervision - Federal Home Loan Bank System." FHLB advances are made pursuant to several different credit programs with varying interest rate, embedded option (callable / putable), amortization, and maturity terms. All of the Bank's FHLB advances outstanding at December 31, 2001 were fixed rate, non-amortizing advances with single individual maturity dates ("bullet advances"). The maximum amount that the FHLB will advance to member institutions, including the Bank, fluctuates from time to time in accordance with the policies of the FHLB. During 2001, the Bank periodically used FHLB advances to provide needed liquidity and to manage the term structure and maturities of its liabilities.

From time to time, the Company enters into reverse repurchase agreements (securities sold under agreements to repurchase) with approved security dealers. Over the past several years, MBBC has in particular utilized securities sold under agreements to repurchase, as the holding company is not eligible for obtaining FHLB advances.

The Bank maintains federal funds lines of credit with four correspondent banks. These lines are not committed lines, but rather function on a funds availability basis. From time to time, the Bank borrows federal funds from its correspondent banks as a source of short term liquidity.

MBBC maintains a committed $3.0 million revolving line of credit with one of the Bank's correspondent banks. This line of credit expires in December 2002, and is collateralized by 800,000 shares of the Company's treasury stock. Funds drawn on the line are priced based upon either the London Inter-Bank Offer Rate curve ("LIBOR") or the correspondent bank's reference rate. This line of credit contains various financial performance covenants on the part of the Company. The line of credit agreement does not restrict the Company's ability to declare and pay cash or stock dividends. The line of credit agreement also contains no restrictions on the use of funds to repurchase Company common stock.

The following table sets forth information regarding the Company's borrowed funds at or for the indicated years.

(Dollars In Thousands)	At Or For The Year Ended	
	2001	200

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FHLB Advances		
Average balance outstanding	$ 47,526	$ 43,94
Weighted average rate on average balance outstanding	5.30%	5.7
Year end balance outstanding	$ 53,582	$ 32,58
Weighted average rate on year end balance outstanding	4.46%	5.4
Maximum amount outstanding at any month end during the year	$ 65,582	$ 50,58
Securities Sold Under Agreements To Repurchase		
Average balance outstanding	$ --	$ 15
Weighted average rate on average balance outstanding	--	6.4
Year end balance outstanding	$ --	$ -
Weighted average rate on year end balance outstanding	--	-
Maximum amount outstanding at any month end during the year	$ --	$ -

Please refer to Notes 11 and 12 to the Consolidated Financial Statements for additional information regarding borrowings and lines of credit.

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Subsidiary Activities

Portola, a California corporation wholly owned by the Bank, is engaged, on an agency basis, in the sale of insurance, mutual funds, individual securities, and annuity products, primarily to the Bank's customers and members of the local communities which the Bank serves. During 2001, gross commission income generated through Portola included $73 thousand for variable annuity sales, $78 thousand for mutual fund sales, and $22 thousand for fixed annuity sales. Portola also functions as trustee for the Bank's deeds of trust. At December 31, 2001, Portola had $101 thousand in total assets. Portola's revenues in 2001 were constrained by the capital markets environment, customer inaction following the events of September 11, 2001, and by turnover in investment sales representatives.

Personnel

As of December 31, 2001, the Company had 119 full-time employees and 16 part-time employees. The employees are not represented by a collective bargaining unit. The Company considers its relationship with its employees to be good.

REGULATION AND SUPERVISION

General

Savings and loan holding companies and savings associations are extensively regulated under both federal and state law. This regulation is intended primarily for the protection of depositors and the Savings Association Insurance Fund ("SAIF") and not for the benefit of stockholders of the Company. The following information describes certain aspects of that regulation applicable to the Company and the Bank, and does not purport to be complete. The following discussion is qualified in its entirety by reference to all particular statutory or regulatory provisions.

Regulation of the Company

General. The Company is a unitary savings and loan holding company subject to regulatory oversight by the Office of Thrift Supervision ("OTS"). As such, the Company is required to register and file reports with the OTS and is subject to regulation and examination by the OTS. In addition, the OTS has enforcement authority over the Company and its subsidiaries, which also permits the OTS to restrict or prohibit activities that are determined to be a serious risk to the subsidiary savings association.

Although savings and loan holding companies are not, at December 31, 2001, subject to specific capital requirements or specific restrictions on the payment of dividends or other capital distributions, the Home Owners Loan Act ("HOLA") does prescribe such restrictions on subsidiary savings institutions, as described below. The Bank must notify the OTS 30 days before declaring any dividend to MBBC.

The HOLA prohibits a savings and loan holding company directly, or indirectly, or through one or more subsidiaries, from acquiring more than 5% of the voting stock of another savings institution or holding company thereof, without prior written approval of the OTS; acquiring or retaining, with certain exceptions, more than 5% of a non-subsidiary company engaged in activities other than those permitted by the HOLA; or acquiring or retaining control of a depository institution that is not insured by the FDIC. In evaluating applications by holding companies to acquire savings institutions, the OTS must consider the financial and managerial resources and future prospects of the company and institution involved, the effect of the acquisition on the risk to the deposit insurance funds, the convenience and needs of the community, and competitive factors.

Activities Restriction Test. As a unitary savings and loan holding company, the Company generally is not subject to activity restrictions, provided the Bank satisfies the Qualified Thrift Lender ("QTL") test or meets the definition of domestic building and loan association pursuant to the Internal Revenue Code of 1986, as amended (the "Code"). The Company presently intends to continue to operate as a unitary savings and loan holding company. Federal legislation terminated the "unitary thrift holding company exemption" for all companies that apply to acquire savings associations after May 4, 1999. Since the Company is grandfathered, its unitary holding company powers and authorities were not affected. See "Financial Services Modernization Legislation." However, if the Company acquires control of another savings association as a separate subsidiary, it would become a multiple savings and loan holding company, and the activities of the Company and any of its subsidiaries (other than the Bank or any other SAIF-insured savings association) would become subject to restrictions applicable to bank holding companies unless such other associations each also qualify as a QTL or domestic building and loan association and were acquired in a supervisory acquisition. Furthermore, if the Company were in the future to sell control of the Bank to any other company, such company would not succeed to the Company grandfathered status under and would be subject to the same business activity restrictions. See "Regulation of the Bank - Qualified Thrift Lender Test."

Restrictions on Acquisitions. MBBC must obtain approval from the OTS before acquiring control of any other SAIF-insured association. Such acquisitions are generally prohibited if they result in a multiple savings and loan holding company controlling savings institutions in more than one state. However, such interstate acquisitions are permitted based on specific state authorization or in a supervisory acquisition of a failing savings association.

Federal law generally provides that no "person," acting directly or indirectly or through or in concert with one or more other persons, may acquire "control," as that term is defined in OTS regulations, of a federally insured savings association without giving at least 60 days written notice to the OTS and providing the OTS an opportunity to disapprove the proposed acquisition. In addition, no company may acquire control of such an institution without prior OTS approval. These provisions also prohibit, among other things, any director or officer of a savings and loan holding company, or any individual who owns or controls more than 25% of the voting shares of a savings and loan holding company, from acquiring control of any savings association not a subsidiary of the savings and loan holding company, unless the acquisition is approved by the OTS. For additional restrictions on the acquisition of a unitary thrift holding company, see "- Financial Services Modernization Legislation."

USA Patriot Act of 2001

On October 26, 2001, President Bush signed the USA Patriot Act of 2001. Enacted in response to the terrorist attacks in New York, Pennsylvania, and Washington, D.C. on September 11, 2001, the Patriot Act is intended is to strengthen U.S law enforcement's and the intelligence communities' abilities to work cohesively to combat terrorism on a variety of fronts. The potential impact of the Act on financial institutions of all kinds is significant and wide ranging. The Act contains sweeping anti-money laundering and financial transparency laws and requires various regulations, including:

- due diligence requirements for financial institutions that administer, maintain, or manage private banks accounts or correspondent accounts for non-US persons

- standards for verifying customer identification at account opening

- rules to promote cooperation among financial institutions, regulators, and law enforcement entities in identifying parties that may be involved in terrorism or money laundering

- reports by non-financial trades and businesses filed with the Treasury Department's Financial Crimes Enforcement Network for transactions exceeding $10,000, and

- filing of suspicious activities reports securities by brokers and dealers if they believe a customer may be violating U.S. laws and regulations.

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Financial Services Modernization Legislation

General. On November 12, 1999, President Clinton signed into law the Gramm-Leach-Bliley Act of 1999 (the "GLB"). The GLB repealed the law prohibiting affiliations banks and securities companies. In addition, the GLB expressly preempted any state law restricting the establishment of financial affiliations primarily related to insurance.

The general effect of the law is to establish a comprehensive framework to permit affiliations among commercial banks, insurance companies, securities firms, and other financial service providers by revising and expanding the Bank Holding Company Act framework to permit a holding company system to engage in a full range of financial activities through a new entity known as a "Financial Holding Company." "Financial activities" is broadly defined to include not only banking, insurance, and securities activities, but also merchant banking and additional activities that the Federal Reserve Board, in consultation with the Secretary of the Treasury, determines to be financial in nature, incidental to such financial activities, or complementary activities that do not pose a substantial risk to the safety and soundness of depository institutions or the financial system generally.

The GLB provides that no company may acquire control of an insured savings association unless that company engages, and continues to engage, only in the financial activities permissible for a Financial Holding Company, unless grandfathered as a unitary savings and loan holding company. The GLB grandfathers any company that was a unitary savings and loan holding company on May 4, 1999 or became a unitary savings and loan holding company pursuant to an application pending on that date. Such a company may continue to operate under present law as long as the company continues to meet the two tests: it can control only one savings institution, excluding supervisory acquisitions, and each such institution must meet the QTL test. Such a grandfathered unitary savings and loan holding company also must continue to control at least one savings association, or a successor institution, that it controlled on May 4, 1999.

The GLB also permits national banks to engage in expanded activities through the formation of financial subsidiaries. A national bank may have a subsidiary engaged in any activity authorized for national banks directly or any financial activity, except for insurance underwriting, insurance investments, real estate investment or development, or merchant banking, which may only be conducted through a subsidiary of a Financial Holding Company. Financial activities include all activities permitted under new sections of the Bank Holding Company Act or permitted by regulation.

The Company and the Bank do not believe that the GLB has had or will have a material adverse effect on their operations in the near-term. However, to the extent that the act permits banks, securities firms, and insurance companies to affiliate, the financial services industry may experience further consolidation. The GLB is intended to grant to community banks certain powers as a matter of right that larger institutions have accumulated on an ad hoc basis and which unitary savings and loan holding companies already possess. Nevertheless, this Act may have the result of increasing the amount of competition that the Company and the Bank face from larger institutions and other types of companies offering financial products, many of which may have substantially more financial resources than the Company and the Bank.

Privacy. Under the GLB, federal banking regulators adopted rules that limit the ability of banks and other financial institutions to disclose non-public information about consumers to nonaffiliated third parties. Pursuant to these rules, effective July 1, 2001, financial institutions must provide:

- initial notices to customers about their privacy policies, describing the conditions under which they may disclose nonpublic personal information to nonaffiliated third parties and affiliates;

- annual notices of their privacy policies to current customers; and

- a reasonable method for customers to "opt out" of disclosures to nonaffiliated third parties.

These privacy provisions affect how consumer information is transmitted through diversified financial companies and conveyed to outside vendors.

Consumer Protection Rules - Sale of Insurance Products. In December 2000, pursuant to the requirements of the GLB, the federal bank and thrift regulatory agencies adopted consumer protection rules for the sale of insurance products by depository institutions. The rules were effective on April 1, 2001. The final rule applies to any depository institution or any person selling, soliciting, advertising, or offering insurance products or annuities to a consumer at an office of the institution or on behalf of the institution. Before an institution can complete the sale of an insurance product or annuity, the regulation requires oral and written disclosure that such product:

- is not a deposit or other obligation of, or guaranteed by, the depository institution or its affiliate;
- is not insured by the FDIC or any other agency of the United States, the depository institution or its affiliate; and
- has certain risks in investment, including the possible loss of value.

Finally, the depository institution may not condition an extension of credit:

- on the consumer's purchase of an insurance product or annuity from the depository institution or from any of its affiliates, or
- on the consumer's agreement not to obtain, or a prohibition on the consumer from obtaining, an insurance product or annuity from an unaffiliated entity.

The rule also requires formal acknowledgement from the consumer that disclosures were received.

In addition, to the extent practicable, a depository institution must keep insurance and annuity sales activities physically segregated from the areas where retail deposits are routinely accepted from the general public.

Regulation of the Bank

General. As a federally chartered, SAIF insured savings association, the Bank is subject to extensive regulation, examination, and supervision by the OTS, as its primary federal regulator, and the FDIC, as the insurer of customer deposits. Lending activities and other investments of the Bank must comply with various statutory and regulatory requirements. The Bank is also subject to certain reserve requirements promulgated by the Board of Governors of the Federal Reserve System ("Federal Reserve Board").

The OTS, in conjunction with the FDIC, regularly examines the Bank and prepares reports for the consideration of the Bank's Board of Directors on any deficiencies found in the operations of the Bank. The relationship between the Bank and depositors and borrowers is also regulated by federal and state laws, especially in such matters as the ownership of deposit accounts and the form and content of mortgage documents utilized by the Bank.

The Bank must file reports with the OTS and the FDIC concerning its activities and financial condition, in addition to obtaining regulatory approvals prior to entering into certain transactions such as mergers with or acquisitions of other financial institutions. This regulation and supervision establishes a comprehensive framework of activities in which an institution can engage and is intended primarily for the protection of the SAIF and depositors.

The OTS and / or the FDIC conduct periodic examinations to test the Bank's safety and soundness, its operations (including technology utilization), and its compliance with applicable laws and regulations, including, but not limited to:

- the Community Reinvestment Act ("CRA")
- the Real Estate Settlement Procedures Act ("RESPA")
- the Bank Secrecy Act ("BSA")
- the Fair Credit Reporting Act ("FCRA")
- the Home Mortgage Disclosure Act ("HMDA")

The regulatory structure provides the regulatory authorities extensive discretion, in connection with their supervisory and enforcement activities and examination policies, across a wide range of the Bank's operations, including, but not limited to:

- loss reserve adequacy
- capital requirements
- credit classification
- limitation or prohibition on dividends
- assessment levels for deposit insurance and examination costs
- permissible branching

Any change in regulatory requirements and policies, whether by the OTS, the FDIC, the Federal Reserve Board, or Congress, could have a material adverse impact on the Company.

Regulatory Capital Requirements And Capital Categories

The following discussion regarding regulatory capital requirements is applicable to the Bank.

Regulatory Capital Requirements. OTS capital regulations require savings institutions to meet three minimum capital standards (as defined by applicable regulations):

- tangible capital equal to 1.5% of adjusted total assets
- leverage capital (core capital) equal to 3.0% of adjusted total assets
- risk-based capital equal to 8.0% of total risk-based assets

The Bank must meet each of these three standards in order to be deemed in compliance with OTS capital requirements. The capital standard applicable to savings institutions must be no less stringent than those for national banks. In addition, the prompt corrective action ("PCA") standards discussed below also establish, in effect, the following minimum standards:

- a 2.0% tangible capital ratio
- a 4.0% leverage (core) capital ratio (3.0% for institutions receiving the highest regulatory rating under the CAMELS rating system)
- a 4.0% Tier One risk based capital ratio

Tangible capital is composed of:

- common stockholders' equity (including retained earnings)
- certain noncumulative perpetual preferred stock and related earnings
- minority interests in equity accounts of consolidated subsidiaries

less:

- intangible assets other than certain asset servicing rights and certain nonsecurity financial instruments
- investments in and loans or advances to subsidiaries engaged in activities as principal, not permissible for a national bank, with certain limited exceptions
- servicing assets in excess of certain thresholds
- deferred tax assets in excess of certain thresholds
- accumulated unrealized gains on certain available for sale securities
- accumulated gains related to qualifying cash flow hedges

plus:

- accumulated unrealized losses on certain available for sale securities
- accumulated losses related to qualifying cash flow hedges

Core capital consists of tangible capital plus various adjustments for certain intangible assets. At December 31, 2001 and 2000, the Bank's tangible capital was equivalent to its core capital, as the Bank did not maintain any qualifying adjustments. In general, total assets calculated for regulatory capital purposes exclude those assets deducted from capital in determining the applicable capital ratio.

The risk based capital standard for savings institutions requires the maintenance of Tier One capital (core capital) and total capital (defined as core capital plus supplementary capital) to risk weighted assets of 4.0% and 8.0%, respectively. In determining the amount of an institution's risk weighted assets, all assets, including certain off balance sheet positions, are multiplied by a risk weight of 0.0% to 100.0%, as assigned by OTS regulations based upon the amount of risk perceived as inherent in each type of asset. The components of supplementary capital include:

- cumulative preferred stock
- long term perpetual preferred stock
- mandatory convertible securities
- certain subordinated debt
- intermediate preferred stock
- the general allowance for loan and lease losses, subject to a limit of 1.25% of risk weighted assets

Overall, the amount of supplementary capital included as part of total capital cannot exceed 100.0% of core capital.

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These regulatory capital requirements are viewed as minimum standards by the OTS, and most institutions are expected to maintain capital levels well above the minimum. In addition, the OTS regulations provide that minimum capital levels higher than those provided in the regulations may be established by the OTS for individual savings associations, upon a determination that the savings association's capital is or may become inadequate in view of its circumstances. The OTS regulations provide that higher individual minimum regulatory capital requirements may be appropriate in circumstances where, among others:

- a savings association has a high degree of exposure to interest rate risk, prepayment risk, credit risk, concentration of credit risk, certain risks arising from nontraditional activities, or similar risks or a high proportion of off-balance sheet risk;

- a savings association is growing, either internally or through acquisitions, at such a rate that supervisory problems are presented that are not dealt with adequately by OTS regulations; or

o a savings association may be adversely affected by activities or condition of its holding company, affiliates, subsidiaries, or other persons, or savings associations with which it has significant business relationships.

The Home Owners' Loan Act ("HOLA") permits savings associations not in compliance with the OTS capital standards to seek an exemption from certain penalties or sanctions for noncompliance. Such an exemption will be granted only if certain strict requirements are met, and must be denied under certain circumstances. If an exemption is granted by the OTS, the savings association still may be subject to enforcement actions for other violations of law or unsafe or unsound practices or conditions.

As disclosed in Note 14 to the Consolidated Financial Statements, at December 31, 2001, the Bank exceeded all minimum and institution specific regulatory capital requirements.

Prompt Corrective Action Regulations. The OTS can levy sanctions against institutions that are not adequately capitalized, with the severity of the sanctions increasing as the institution's capital declines. The OTS has established specific capital ratios under the Prompt Corrective Action ("PCA") Regulations for five separate capital categories:

1. Well Capitalized

Total risk based capital ratio of at least 10.0%
Tier One risk based capital ratio of at least 6.0%
Leverage ratio of at least 5.0%

2. Adequately Capitalized

Total risk based capital ratio of at least 8.0%
Tier One risk based capital ratio of at least 4.0%
Leverage ratio of at least 4.0%

3. Under Capitalized

Total risk based capital ratio of
Tier One risk based capital ratio
Leverage ratio of less than 4.0%

4. Significantly Under Capitaliz

Total risk based capital ratio of
Tier One risk based capital ratio
Leverage ratio of less than 3.0%

5. Critically Under Capitalized

Tangible capital of less than 2.0

In general, the prompt corrective action regulation prohibits an insured depository institution from declaring any dividends, making any other capital distribution, or paying a management fee to a controlling person if, following the distribution or payment, the institution would be within any of the three undercapitalized categories. In addition, adequately capitalized institutions may accept brokered deposits only with a waiver from the FDIC and are subject to restrictions on the interest rates that can be paid on such deposits. Undercapitalized institutions may not accept, renew, or roll-over brokered deposits.

If the OTS determines that an institution is in an unsafe or unsound condition, or if the institution is deemed to be engaging in an unsafe and unsound practice, the OTS may, if the institution is well capitalized, reclassify it as adequately capitalized; if the institution is adequately capitalized but not well capitalized, require it to comply with restrictions applicable to undercapitalized institutions; and, if the institution is undercapitalized, require it to comply with certain restrictions applicable to significantly undercapitalized institutions. Finally, pursuant to an interagency agreement, the FDIC can examine any institution that has a substandard regulatory examination score or is considered undercapitalized - without the express permission of the institution's primary regulator.

As disclosed in Note 14 to the Consolidated Financial Statements, at December 31, 2001, the Bank met the requirements to be classified as a "well capitalized" institution under Prompt Corrective Action regulations. At December 31, 2001, the Bank was eligible to acquire brokered deposits, but had none.

Special OTS Capital Requirements. During the first quarter of 2000, the Bank was informed by the OTS that:

1. All loans associated with the pool of residential mortgages acquired from a seller / servicer that guaranteed the pool (the "Special Residential Loan Pool") be assigned to the 100% risk based capital category in calculating capital ratios that incorporate risk weighted assets. See "Credit Quality - Special Residential Loan Pool" and Note 14 to the Consolidated Financial Statements.

2. The Bank's regulatory capital position at December 31, 1999 was required to reflect this requirement.

3. Until further notice, the Bank's regulatory capital ratios were required to be maintained at levels no lower than the levels at December 31, 1999.

The Bank continually complied with the above special requirements through December 31, 2001. In early 2002, the Bank received notification from the OTS that the institution specific regulatory capital requirements described above have been eliminated.

Regulatory Capital Requirements Associated With Subprime Lending. As a result of a number of federally insured financial institutions extending their risk selection standards to attract lower credit quality accounts due to such credits having higher interest rates and fees, the federal banking regulatory agencies jointly issued Interagency Guidelines on Subprime Lending. Subprime lending involves extending credit to individuals with less than perfect credit histories.

The agencies' guidelines provide that if the risks associated with subprime lending are not properly controlled, the agencies consider subprime lending a high-risk activity that is unsafe and unsound. Specifically, the guidelines direct examiners to expect regulatory capital one and one-half to three times higher than that typically set aside for prime assets for institutions that:

- have subprime assets equal to 25% or higher of Tier 1 capital; or

- have subprime portfolios experiencing rapid growth or adverse performance trends, administered by inexperienced management, or having inadequate or weak controls.

The Bank does not normally engage in subprime lending. However, substantially all of the Special Residential Loan Pool (see "Credit Quality - Special Residential Loan Pool" and Note 14 to the Consolidated Financial Statements), if owned without the credit guaranty of the seller / servicer, would qualify as subprime lending. Management believes that the seller / servicer of the Special Residential Loan Pool has considerable experience in administering subprime residential mortgages.

Predatory Lending. The term "predatory lending", much like the terms "safety and soundness" and "unfair and deceptive practices," is far-reaching and covers a potentially broad range of behavior. As such, it does not lend itself to a concise or a comprehensive definition. But typically predatory lending involves at least one, and perhaps all three, of the following elements:

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

On December 14, 2001, the Federal Reserve Board amended its regulations aimed at curbing predatory lending. Compliance is not mandatory until October 1, 2002. The rule significantly widens the pool of high-cost home-secured loans covered by the Home Ownership and Equity Protection Act of 1994 ("HOPEA"), a federal law that requires extra disclosures and consumer protections to borrowers. The following triggers coverage under HOPEA:

- interest rates for first lien mortgage loans in excess of 8 percentage points above comparable term Treasury securities;
- subordinate-lien loans of 10 percentage points above comparable term Treasury securities; or
- fees such as optional insurance and similar debt protection costs paid in connection with the credit transaction, when combined with points and fees if deemed excessive.

In addition, the regulation bars loan flipping by the same lender or loan servicer within a year. Lenders also will be presumed to have violated the law -- which says loans shouldn't be made to people unable to repay them -- unless they document that the borrower has the ability to repay. Lenders that violate the rules face cancellation of loans and penalties equal to the finance charges paid.

Because the Bank does not engage in the various practices generally referenced as "predatory lending", management does not anticipate any material impact from these rule changes and potential state action in this area on its financial condition or results of operation.

Safety and Soundness Standards

The OTS has established minimum standards to promote early identification of management problems at depository institutions and to ensure that regulators intervene promptly to require corrective action by institutions with inadequate operational and managerial controls related to:

- internal controls, information systems, and internal audit systems
- loan documentation
- credit underwriting
- asset growth
- earnings

- interest rate risk exposure
- compensation, fees, and benefits

If the OTS determines that an institution fails to meet any of these minimum standards, the agency may require the institution to submit to the agency an acceptable plan to achieve compliance with the standard. In the event the institution fails to submit an acceptable plan within the time allowed by the agency or fails in any material respect to implement an accepted plan; the agency must, by order, require the institution to correct the deficiency and may implement a series of supervisory sanctions.

The federal banking agencies (including the OTS) have promulgated safety and soundness regulations and accompanying interagency compliance guidelines on asset quality and earnings standards. These guidelines provide six standards for establishing and maintaining a system to identify problem assets and prevent those assets from deteriorating. The institution should:

1. conduct periodic asset quality reviews to identify problem assets

2. estimate the inherent losses in those assets and establish reserves that are sufficient to absorb estimated losses

3. compare problem asset totals to capital

4. take appropriate corrective action to resolve problem assets

5. consider the size and potential risks of material asset concentrations

6. provide periodic asset reports with adequate information for management and the board of directors to assess the level of asset risk

These guidelines also set forth standards for evaluating and monitoring earnings and for ensuring that earnings are sufficient for the maintenance of adequate capital and reserves. If the institution fails to comply with a safety and soundness standard, the appropriate federal banking agency may require the institution to submit a compliance plan. Failure to submit a compliance plan or to implement an accepted plan may result in enforcement action.

Potential Enforcement Actions

The OTS has primary enforcement responsibility over savings institutions and maintains the authority to bring actions against the institution and all institution affiliated parties, as defined under the applicable regulations, for unsafe or unsound practices in conducting their businesses or for violations of any law, rule, regulation, condition imposed in writing by the agency, or any written agreement with the agency. Enforcement actions may include the imposition of a conservator or receiver, the issuance of a cease and desist order that can be judicially enforced, the termination of insurance of deposits (in the case of the Bank), the imposition of civil money penalties, the issuance of directives to increase capital, the issuance of formal and informal agreements, the issuance of removal or prohibition orders against institution affiliated parties, and the imposition of restrictions under the PCA provisions of FDICIA. Federal law also establishes criminal penalties for certain violations.

Under the FDI Act, the FDIC has the authority to recommend to the Director of the OTS enforcement action to be taken with respect to a particular savings institution. If action is not taken by the Director of the OTS, the FDIC has authority to take such action under certain circumstances.

Additionally, a holding company's inability to serve as a source of strength to its subsidiary financial institutions could serve as an ancillary basis for regulatory action against the holding company. Neither MBBC, the Bank, or any subsidiary thereof are currently subject to any enforcement actions

Insurance of Deposit Accounts

The Bank's deposit accounts are presently insured by the SAIF, except for certain acquired deposits that are insured by the BIF, up to the maximum permitted by law. The SAIF and the BIF are administered by the FDIC. Insurance of deposits may be terminated by the FDIC upon a finding that the institution:

- has engaged in unsafe or unsound practices;
- is in an unsafe or unsound condition to continue operations; or
- has violated any applicable law, regulation, rule, order, or condition imposed by the FDIC or the institution's primary regulator.

The management of the Bank does not know of any practice, condition, or violation that might lead to the termination of deposit insurance.

The FDIC currently assesses its premiums based upon the insured institution's position on two factors:

1. the institution's capital category under PCA regulations
2. the institution's supervisory category as determined by the FDIC based upon supervisory information provided by the institution's primary federal regulator and other information deemed pertinent by the FDIC

The supervisory categories are:

- Group A: financially sound with only a few minor weaknesses
- Group B: demonstrates weaknesses that could result in significant deterioration
- Group C: poses a substantial probability of loss

Annual FDIC deposit insurance assessment rates as of January 1, 2002 were as follows:

As Of January 1, 2002	FDIC Deposit Insurance Rates Expressed In Terms Of Annual Cents Per $100 of Assessed Deposits		
	Group A	Group B	Group C
PCA Capital Category			
Well capitalized	0	3	17
Adequately capitalized	3	10	24
Under capitalized	10	24	27

As of January 1, 2002, the Bank had been notified by the FDIC that its deposit insurance assessment rate during the first half of calendar 2002 would be 3 basis points. The Bank anticipates its deposit insurance assessment rate to decrease to zero basis points during the second half of calendar 2002, subject to possible changes in the FDIC insurance premium formula.

In addition to the deposit insurance premiums presented in the above table, both BIF and SAIF insured institutions must also pay FDIC premiums related to the servicing of Financing Corporation ("FICO") bonds. FICO is an agency of the federal government that was established to recapitalize the predecessor to the SAIF. These assessments will continue until the FICO bonds mature in 2017. The current annual assessment rate for the FICO bonds is approximately 2 basis points per annum on insured deposits.

In early 2002, Congress was considering various new laws applicable to FDIC insurance premiums and insurance coverage. See "Potential Federal Legislation and Regulation".

Branching

OTS regulations permit nationwide branching by federally chartered savings institutions to the extent allowed by federal statute. This permits federal savings institutions to establish interstate networks and to geographically diversify their loan portfolios and lines of business. The OTS authority preempts any state law purporting to regulate branching by federal savings institutions. At this time, the Company's management has no plans to establish physical branches outside of California, although the Bank does serve customers domiciled outside of California via alternative delivery channels such as telephone, mail, the Internet, and ATM networks.

Transactions With Related Parties

Transactions between a savings association and its "affiliates" are quantitatively and qualitatively restricted under the Federal Reserve Act. Affiliates of a savings association include, among other entities, the savings association's holding company and companies that are under common control with the savings association. In general, a savings association or its subsidiaries are limited in their ability to engage in "covered transactions" with affiliates:

o to an amount equal to 10% of the association's capital and surplus, in the case of covered transactions with any one affiliate; and

o to an amount equal to 20% of the association's capital and surplus, in the case of covered transactions with all affiliates.

In addition, a savings association and its subsidiaries may engage in covered transactions and other specified transactions only on terms and under circumstances that are substantially the same, or at least as favorable to the savings association or its subsidiary, as those prevailing at the time for comparable transactions with nonaffiliated companies. A "covered transaction" includes:

o a loan or extension of credit to an affiliate

o a purchase of investment securities issued by an affiliate

o a purchase of assets from an affiliate, with some exceptions

o the acceptance of securities issued by an affiliate as collateral for a loan or extension of credit to any party

o the issuance of a guarantee, acceptance, or letter of credit on behalf of an affiliate

In addition, under the OTS regulations:

- a savings association may not make a loan or extension of credit to an affiliate unless the affiliate is engaged only in activities permissible for bank holding companies;

- a savings association may not purchase or invest in securities of an affiliate other than shares of a subsidiary;

- a savings association and its subsidiaries may not purchase a low-quality asset from an affiliate;

- covered transactions and other specified transactions between a savings association or its subsidiaries and an affiliate must be on terms and conditions that are consistent with safe and sound banking practices; and

- with some exceptions, each loan or extension of credit by a savings association to an affiliate must be secured by collateral with a market value ranging from 100% to 130%, depending on the type of collateral, of the amount of the loan or extension of credit.

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OTS regulation generally excludes all non-bank and non-savings association subsidiaries of savings associations from treatment as affiliates, except to the extent that the OTS or Federal Reserve decides to treat these subsidiaries as affiliates. The regulation also requires savings associations to make and retain records that reflect affiliate transactions in reasonable detail and provides that specific classes of savings associations may be required to give the OTS prior notice of affiliate transactions.

The Bank's authority to extend credit to executive officers, directors, and 10% shareholders, ("insiders"), as well as entities such persons control, is governed by the Federal Reserve Act and Regulation O thereunder. Among other things, such loans are required to be made on terms substantially the same as those offered to unaffiliated individuals and to not involve more than the normal risk of repayment. Specific legislation created an exception for loans made pursuant to a benefit or compensation program that is widely available to all employees of the institution and does not give preference to insiders over other employees. Regulation O also places individual and aggregate limits on the amount of loans the Bank may make to insiders based, in part, on the Bank's capital position and requires certain Board approval procedures to be followed. For information concerning loans to executive officers and directors of the Company, please refer to Note 5 to the Consolidated Financial Statements.

Community Reinvestment Act and Fair Lending Laws

Savings associations have a responsibility under the Community Reinvestment Act ("CRA") and related regulations of the OTS to help meet the credit needs of their communities. The CRA generally requires most insured depository institutions to:

- identify and delineate the communities served through and by the institution's offices
- affirmatively meet the credit needs of their delineated communities, including low and moderate income neighborhoods
- market the types of credit the institution is prepared to extend within such communities

The CRA requires the OTS to assess the performance of the institution in meeting the credit needs of its communities and to take such assessment into consideration in reviewing applications for mergers, acquisitions, and other transactions. An unsatisfactory CRA rating may be the basis for denying such an application. In addition, federal banking agencies may take compliance with CRA into account when regulating and supervising other activities.

The Equal Credit Opportunity Act and the Fair Housing Act prohibit lenders from discriminating in their lending practices on the basis of characteristics specified in those statutes. In addition, an institution's failure to comply with the Equal Credit Opportunity Act and the Fair Housing Act could result in the OTS, other federal regulatory agencies, or the Department of Justice taking enforcement actions.

An institution's CRA performance is assessed on the basis of the institution's actual lending, service, and investment performance. In connection with its assessment of the Bank's CRA performance, the OTS assigns one of the following ratings:

- outstanding
- satisfactory
- needs improvement
- substantial noncompliance

Based upon its most recent CRA examination, the Bank received a "satisfactory" CRA rating.

Effective January 1, 2002, the OTS raised the dollar amount limit in the definition of small business loans from $500,000 to $2.0 million, if used for commercial, corporate, business, or agricultural purposes. Furthermore, the rule raises the aggregate level that a thrift can invest directly in community development funds, community centers, and economic development initiatives in its communities from the greater of a quarter of one percent of total capital or $100,000 to one percent of total capital or $250,000.

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Qualified Thrift Lender Test

The HOLA requires savings associations to meet a qualified thrift lender ("QTL") test. A savings association is permitted to meet the QTL test in one of two alternative ways. Under the first method, in at least nine out of every twelve months, the thrift institution is required to maintain at least 65% of its "portfolio assets," defined as total assets less (i) specified liquid assets up to 20% of total assets, (ii) intangible assets, including goodwill and (iii) the value of property used to conduct business, in certain "qualified thrift investments." Assets constituting qualified thrift investments include residential mortgages, qualifying mortgage backed securities, educational loans, small business loans, and credit card loans. Certain other types of assets also qualify as "qualified thrift investments" up to certain limitations. These limited other types of assets include home equity lines of credit and consumer loans. Alternatively, savings institutions are permitted to meet the QTL test by qualifying as a "domestic building and loan association" under the Internal Revenue Code by meeting the Code's 60% of assets test in nine out of every twelve months.

Savings associations that fail to meet the QTL test will generally be prohibited from engaging in any activity not permitted for both a national bank and a savings association. A savings association that fails the QTL test may be required to convert to a commercial bank charter. At December 31, 2001, the Bank maintained 74.5% of its portfolio assets in qualified thrift investments and, therefore, met the QTL test.

Loans To One Borrower Limitations

Savings associations generally are subject to the lending limits applicable to national banks. With certain limited exceptions, the maximum amount that a savings association or a national bank may lend to any borrower (including certain related entities of the borrower) at one time may not exceed 15% of the unimpaired capital and surplus of the institution, plus an additional 10% of unimpaired capital and surplus for loans fully secured by readily marketable collateral. The term "unimpaired capital and surplus" is defined as an institution's regulatory capital, plus that portion of an institution's general valuation allowances that is not includable in the institution's regulatory capital. "Readily marketable collateral" is defined to include certain financial instruments and specifically excludes real estate.

Savings associations are additionally authorized to make loans to one borrower, for any purpose, in an amount not to exceed $500,000 or, by order of the Director of OTS, in an amount not to exceed the lesser of $30,000,000 or 30% of unimpaired capital and surplus to develop residential housing, provided:

- the purchase price of each single-family dwelling in the development does not exceed $500,000;
- the savings association is in compliance with its regulatory capital requirements;
- the loans comply with applicable loan-to-value requirements; and
- the aggregate amount of loans made under this authority does not exceed 150% of unimpaired capital and surplus.

At December 31, 2001, the Bank's limit on loans to one borrower was $7.6 million. At December 31, 2001, the Bank's largest aggregate outstanding balance of loans to one borrower totaled approximately $6.4 million. These loans were associated with an upscale residential development in the Bank's primary market area, and were all performing in accordance with their terms. The Bank has conducted significant lending in this residential development for the past several years. The Bank's second largest aggregate outstanding balance of loans to one borrower at December 31, 2001 totaled approximately $5.6 million. This position arose as the result of a credit guarantee by a seller / servicer of a pool of residential mortgages, as more fully detailed under "Credit Quality - Special Residential Loan Pool" and Note 14 to the Consolidated Financial Statements.

Limitations On Capital Distributions

OTS regulations impose limitations upon all capital distributions by savings institutions, such as cash dividends, payments to repurchase or otherwise acquire its shares, payments to shareholders of another institution in a cash-out merger, and other distributions charged against capital. Under current regulations, a savings association in some circumstances may:

- be required to file an application and await approval from the OTS before it makes a capital distribution
- be required to file a notice 30 days before the capital distribution

- be permitted to make the capital distribution without notice or application to the OTS

The OTS regulations require a savings association to file an application if:

- it is not eligible for expedited treatment of its other applications under OTS regulations

- the total amount of all of capital distributions, including the proposed capital distribution, for the applicable calendar year exceeds its net income for that year to date plus retained net income for the preceding two years

- it would not be at least adequately capitalized, under the prompt corrective action regulations of the OTS, following the distribution

- the association's proposed capital distribution would violate a prohibition contained in any applicable statute, regulation, or agreement between the savings association and the OTS, or the FDIC, or violate a condition imposed on the savings association in an OTS-approved application or notice

In addition, a savings association must give the OTS notice of a capital distribution if the savings association is not required to file an application, but:

- would not be well capitalized under the prompt corrective action regulations of the OTS following the distribution

- the proposed capital distribution would reduce the amount of or retire any part of the savings association's common or preferred stock or retire any part of debt instruments like notes or debentures included in capital, other than regular payments required under a debt instrument approved by the OTS

- the savings association is a subsidiary of a savings and loan holding company (applicable to the Bank)

The OTS may prohibit a proposed capital distribution that would otherwise be permitted if the OTS determines that the distribution would constitute an unsafe or unsound practice. Further, a federal savings association, like the Bank, cannot distribute regulatory capital that is needed for its liquidation account.

Activities of Subsidiaries

A savings association seeking to establish a new subsidiary, acquire control of an existing company or conduct a new activity through a subsidiary must provide 30 days prior notice to the FDIC and the OTS and conduct any activities of the subsidiary in compliance with regulations and orders of the OTS. The OTS has the power to require a savings association to divest any subsidiary or terminate any activity conducted by a subsidiary that the OTS determines to pose a serious threat to the financial safety, soundness, or stability of the savings association or to be otherwise inconsistent with sound banking practices.

Restrictions On Investments And Loans

OTS regulations do not permit the Bank to invest directly in equity securities (with certain very limited exceptions), non investment grade debt securities, or real estate, other than real estate used for the institution's offices and facilities. Indirect equity investment in real estate through a subsidiary, such as Portola, is permissible, but is subject to certain limitations and deductions from regulatory capital. The Company's management has no plans to pursue real estate development or real estate investment activity through Portola.

The OTS and other federal banking agencies have jointly adopted uniform rules on real estate lending and related Interagency Guidelines for Real Estate Lending Policies (the "Guidelines"). The uniform rules require that institutions adopt and maintain comprehensive written policies for real estate lending. The policies must reflect consideration of the Guidelines and must address relevant lending procedures, such as loan to value limitations, loan administration procedures, portfolio diversification standards and documentation, and approval and reporting requirements. Although the uniform rules do not impose specific maximum loan to value ratios, the related Guidelines state that such ratio limits established by an individual institution's board of directors generally should not exceed levels set forth in the Guidelines, which range from a maximum of 65% for loans secured by unimproved land to 85% for improved property. No limit is set for single family residential mortgages, but the Guidelines state that such loans equal to or exceeding a 90.0% loan to value ratio should have private mortgage insurance or some other form of credit enhancement. The Guidelines further permit a limited amount of loans that do not conform to these criteria. In addition, aggregate loans secured by non-residential real property are generally limited to 400% of a thrift institution's total capital, as defined.

Classification Of Assets

Thrift institutions are required to classify their assets on a regular basis, to establish appropriate allowances for losses, and to report the results of such classifications quarterly to the OTS. A thrift institution is also required to set aside adequate valuation allowances, and to establish liabilities for off balance sheet items, such as letters of credit, when loss becomes probable and estimable. The OTS has the authority to review the institution's classification of its assets and to determine whether and to what extent (i) additional assets must be classified, and (ii) whether the institution's allowances must be increased. Such instruction by the OTS to increase valuation allowances could have a material impact upon both the Company's reported earnings and its financial condition.

The OTS and the other federal banking regulatory agencies have adopted an interagency policy statement regarding the appropriate levels of valuation allowances for loan and lease losses that insured depository institutions should maintain. Under this policy statement, examiners will generally accept management's evaluation of the adequacy of valuation allowances if the institution has:

- maintained effective systems and controls for identifying and addressing asset quality problems

- analyzed in a reasonable manner all significant factors that affect the collectibility of the portfolio

- established an acceptable process for evaluating the adequacy of valuation allowances

However, the policy statement also provides that OTS examiners will review management's analysis more closely if valuation allowances do not at least equal the following benchmarks:

- o 15% of assets classified as substandard
- o 50% of assets classified as doubtful
- o for the portfolio of unclassified loans and leases, an estimate of credit losses over the upcoming twelve months based upon the institution's recent average rate of net charge-offs on similar loans, adjusted for current trends and conditions

The Company's internal credit policy is to comply with the interagency policy statement and to maintain adequate reserves for estimable losses. However, the determination of estimable losses is by nature an uncertain practice, and hence no assurance can be given that the Company's loss allowances will prove adequate to cover future losses.

Assessments

Thrift institutions are required to pay assessments to the OTS to fund the agency's operations. The general assessment, paid on a semi-annual basis, is computed based upon a three component equation. The components are total assets, regulatory rating, and amount and nature of off balance sheet activities. The Bank's general assessment for the six month period commencing January 1, 2002 was $56 thousand. The general assessments paid by the Bank for the fiscal year ended December 31, 2001 totaled $141 thousand.

Federal Home Loan Bank ("FHLB") System

The Bank is a member of the Federal Home Loan Bank of San Francisco ("FHLB-SF"). Each Federal Home Loan Bank serves as a reserve or central bank for its members within its assigned geographic region. Each Federal Home Loan Bank is financed primarily from the sale of consolidated obligations of the FHLB system. The FHLB-SF provides a comprehensive credit facility and various correspondent services to member institutions. Each FHLB makes available loans or advances to its members in compliance with the policies and procedures established by the Board of Directors of the individual FHLB. As a member of the FHLB-SF, the Bank is required to own capital stock in an amount at least equal to the greater of:

- o 1.0% of the aggregate principal amount of outstanding residential loans and mortgage backed securities, as defined, at the beginning of each calendar year
- o 5.0% of its advances from the FHLB

At its most recent evaluation, the Bank was in compliance with this requirement. FHLB advances must be secured by specific types of collateral, including various types of mortgage loans and securities, and the Bank's investment in the capital stock of the FHLB. It is the policy of the Bank to maintain an excess of pledged collateral with the FHLB-SF at all times to serve as a ready source of additional liquidity.

The FHLB's are required to provide funds to contribute toward the payment of certain bonds issued in the past to fund the resolution of insolvent thrifts. In addition, FHLB's are required by statute to contribute funds toward affordable housing programs. These requirements could reduce the amount of dividends the FHLB's pay on their capital stock and could also negatively impact the pricing offered for on and off balance sheet credit products - events that could unfavorably impact the profitability of the Company.

The Gramm-Leach-Bliley Act made significant reforms to the FHLB system, including:

- o Expanded Membership - (i) expands the uses for, and types of, collateral for advances; (ii) eliminates bias toward QTL lenders; and (iii) removes capital limits on advances using real estate related collateral (e.g., commercial real estate and home equity loans)

- o New Capital Structure - each FHLB is allowed to establish two classes of stock: Class A is redeemable within six months of notice; and Class B is redeemable within five years notice. Class B is valued at 1.5 times the value of Class A stock. Each FHLB will be required to maintain minimum capital equal to 5% of equity.

- o Voluntary Membership - federally chartered savings associations, such as the Bank, are no longer required to be members of the system.

- o REFCorp Payments - changes the amount paid by the system on debt incurred in connection with the thrift crisis in the late 1980s from a fixed amount to 20% of net earnings after deducting certain expenses.

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As required by the FHLB System Modernization Act of 1999, the FHLB-SF has recently submitted its proposed capital plan to the Federal Housing Finance Board for approval. In early 2002, the Federal Housing Finance Board was evaluating the FHLB-SF's proposed capital plan, as well as the proposed capital plans of the other 11 Federal Home Loan Banks. Following the approval of the FHLB-SF's capital plan as submitted or as required to be modified, the FHLB-SF will give members at least 240 days written notice of the implementation date for the final capital plan. This advance notice period is designed to provide members with sufficient time to evaluate the final plan and make any associated decisions or elections involving their membership. Based upon a review of the most recent proposed FHLB-SF capital plan, management does not anticipate a material impact to the Company's results of operations, financial condition, or investment requirement in FHLB capital stock if the most recent FHLB-SF proposed capital plan is approved as submitted.

Federal Reserve System

The Federal Reserve Board ("FRB") requires insured depository institutions to maintain non-interest-earning ("sterile") reserves against certain of their transactional accounts (primarily deposit accounts that may be accessed by writing unlimited checks). At December 31, 2001, the regulations generally required that reserves be maintained against qualified net transaction accounts as follows:

First $5.7 million	Exempt
Next $35.6 million	3.0%
Amount above $41.3 million	10.0%

The reserve requirement may be met by certain qualified cash balances. For the calculation period including December 31, 2001, the Bank was in compliance with its FRB reserve requirements. As a creditor and an insured depository institution, the Bank is subject to certain regulations promulgated by the FRB, including, but not limited to:

Regulation B	Equal Credit Opportunity Act
Regulation C	Home Mortgage Disclosure Act
Regulation D	Reserve Requirements
Regulation E	Electronic Funds Transfers Act
Regulation F	Limits On Interbank Liabilities
Regulation O	Extensions Of Credit To Insiders
Regulation P	Privacy Of Consumer Financial Information
Regulation X	Real Estate Settlement Procedures Act
Regulation Z	Truth In Lending Act
Regulation CC	Expedited Funds Availability Act
Regulation DD	Truth In Savings Act

Potential Federal Legislation and Regulation

The US Congress continues to consider a broad range of legislative initiatives that might impact the financial services industry. Among these initiatives are:

- the potential merger of the BIF and SAIF insurance funds of the FDIC
- potential FDIC deposit insurance reforms, including an increase in the amount of coverage, indexing of coverage limits for inflation, changes in coverage for municipal deposits and retirement accounts, and modifications in the assessment formula for FDIC insurance, perhaps to include granting the FDIC greater latitude in setting deposit insurance premium rates and determining an adequate level of designated reserve coverage
- the potential for insured depository institutions to pay interest on business checking deposits, perhaps in conjunction with authorization for the Federal Reserve to pay interest on sterile reserves
- the potential relaxation of transaction count restrictions on money market demand deposits, thereby facilitating internal fund "sweeps" (of particular benefit to smaller financial institutions such as the Bank)
- possible modifications in federal bankruptcy laws, including potential revisions that would encourage Chapter 13 filings (with payment requirements) versus Chapter 7 filings (debt forgiveness)

US financial institution regulatory agencies were considering at December 31, 2001 a series of potential regulatory changes or additions, including:

- increased information reporting requirements under Regulation C
- enhanced enforcement procedures associated with Regulation X
- expanded investment powers for federally chartered credit unions
- revisions to bank regulatory capital requirements
- modifications to CRA compliance rules

The Company cannot predict what legislation and regulation, if any, might emerge from Congress and the various federal regulatory agencies, and the potential impact of such legislation and regulation upon the Company.

Environmental Regulation

The Company's business and properties are subject to federal and state laws and regulations governing environmental matters, including the regulation of hazardous substances and wastes. For example, under the federal Comprehensive Environmental Response, Compensation, and Liability Act ("CERCLA") and similar state laws, owners and operators of contaminated properties may be liable for the costs of cleaning up hazardous substances without regard to whether such persons actually caused the contamination. Such laws may affect the Company as an owner or operator of properties used in its business, and through the Bank, as a secured lender of property that is found to contain hazardous substances or wastes.

Although CERCLA and similar state laws generally exempt holders of security interests, the exemption may not be available if a secured party engages in the management of its borrower or the securing property in a manner deemed beyond the protection of the secured party's interest. Recent federal and state legislation, as well as guidance issued by the United State Environmental Protection Agency and a number of court decisions, have provided assurance to lenders regarding the activities they may undertake and remain within CERCLA's secured party exemption. However, these assurances are not absolute and generally will not protect a lender or fiduciary that participates or otherwise involves itself in the management of its borrower, particularly in foreclosure proceedings. As a result, CERCLA and similar state statutes may influence the Bank's decision whether to foreclose on property that may be or is found to be contaminated. The Bank has adopted environmental underwriting requirements for commercial and industrial real estate loans. The Bank's general policy is to obtain an environmental assessment prior to foreclosure on commercial and industrial real estate. See "Business - General" and "Lending Activities - Loan Portfolio Composition" regarding the recent expansion in the Bank's commercial and industrial real estate loan portfolio. The existence of hazardous substances or wastes on commercial and industrial real estate properties could cause the Bank to elect not to foreclose on the property, thereby limiting, and in some cases precluding, the Bank from realizing on the related loan. Should the Bank foreclose on property containing hazardous substances or wastes, the Bank could become subject to other environmental statutes, regulations, and common law relating to matters such as, but not limited to, asbestos abatement, lead-based paint abatement, hazardous substance investigation and remediation, air emissions, wastewater discharges, hazardous waste management, and third party claims for personal injury and property damage.

Federal Securities Laws

The Company's common stock is registered with the SEC under Section 12(g) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). The Company is subject to periodic reporting requirements, proxy solicitation rules, insider trading restrictions, tender offer rules, and other requirements under the Exchange Act. In addition, certain activities of the Company, its executive officers, and directors are covered under the Securities Act of 1933, as amended (the "Securities Act").

Non-Banking Regulation

The Company is impacted by many other laws and regulations, not necessarily unique to insured depository institutions. Among these other laws and regulations are federal bankruptcy laws.

Federal Taxation

General. The Bank and the Company report their income on a consolidated basis using the accrual method of accounting and will be subject to federal income taxation in the same manner as other corporations with some exceptions, including particularly the Bank's reserve for bad debts discussed below. The following discussion of tax matters is intended only as a summary and does not purport to be a comprehensive description of the tax rules applicable to the Bank or the Company. The Bank has not been audited by the IRS during the last five years. For its 2001 taxable year, the Bank is subject to a maximum federal income tax rate of 35%.

Bad Debt Reserve. For fiscal years beginning prior to December 31, 1995, thrift institutions which qualified under certain definitional tests and other conditions of the Internal Revenue Code of 1986 (the "Code") were permitted to use certain favorable provisions to calculate their deductions from taxable income for annual additions to their bad debt reserve. A reserve could be established for bad debts on qualifying real property loans (generally secured by interests in real property improved or to be improved) under (i) the Percentage of Taxable Income Method (the "PTI Method") or (ii) the Experience Method. The reserve for nonqualifying loans was computed using the Experience Method.

The Small Business Job Protection Act of 1996 (the "1996 Act"), which was enacted on August 20, 1996, requires savings institutions to recapture (i.e., take into income) certain portions of their accumulated bad debt reserves. The 1996 Act repeals the reserve method of accounting for bad debts effective for tax years beginning after 1995. Thrift institutions that would be treated as small banks are allowed to utilize the Experience Method applicable to such institutions, while thrift institutions that are treated as large banks (those generally exceeding $500 million in assets) are required to use only the specific charge-off method. Thus, the PTI Method of accounting for bad debts is no longer available for any financial institution.

A thrift institution required to change its method of computing reserves for bad debts will treat such change as a change in method of accounting, initiated by the taxpayer, and having been made with the consent of the IRS. Any Section 481 (a) adjustment required to be taken into income with respect to such change generally will be taken into income ratably over a six-taxable year period, beginning with the first taxable year beginning after 1995, subject to the residential loan requirement.

Under the residential loan requirement provision, the recapture required by the 1996 Act will be suspended for each of two successive taxable years, beginning with the Bank's current taxable year, in which the Bank originates a minimum of certain residential loans based upon the average of the principal amounts of such loans made by the Bank during its six taxable years preceding its current taxable year.

Under the 1996 Act, for its current and future taxable years, the Bank is permitted to make additions to its tax bad debt reserves. In addition, the Bank is required to recapture (i.e., take into income) over a six year period the excess of the balance of its tax bad debt reserves as of December 31, 1995 over the balance of such reserves as of December 31, 1987.

Distributions. Under the 1996 Act, if the Bank makes "non-dividend distributions" to the Company, such distributions will be considered to have been made from the Bank's unrecaptured tax bad debt reserves (including the balance of its reserves as of December 31, 1987) to the extent thereof, and then from the Bank's supplemental reserve for losses on loans, to the extent thereof, and an amount based on the amount distributed (but not in excess of the amount of such reserves) will be included in the Bank's income. Non-dividend distributions include distributions in excess of the Bank's current and accumulated earnings and profits, as calculated for federal income tax purposes, distributions in redemption of stock, and distributions in partial or complete liquidation. Dividends paid out of the Bank's current or accumulated earnings and profits will not be so included in the Bank's income.

The amount of additional taxable income triggered by a non-dividend is an amount that, when reduced by the tax attributable to the income, is equal to the amount of the distribution. Thus, if the Bank makes a non-dividend distribution to the Company, approximately one and one-half times the amount of such distribution (but not in excess of the amount of such reserves) would be includable in income for federal income tax purposes, assuming a 35% federal corporate income tax rate. The Bank does not intend to pay dividends that would result in a recapture of any portion its bad debt reserves.

Corporate Alternative Minimum Tax. The Internal Revenue Code of 1986, as amended (the "Code") imposes a tax on alternative minimum taxable income ("AMTI") at a rate of 20%. The excess of the bad debt reserve deduction using the percentage of taxable income method over the deduction that would have been allowable under the experience method is treated as a preference item for purposes of computing the AMTI. Only 90% of AMTI can be offset by net operating loss carryovers of which the Bank currently has none. AMTI is increased by an amount equal to 75% of the amount by which the Bank's adjusted current earnings exceeds its AMTI (determined without regard to this preference and prior to reduction for net operating losses). In addition, for taxable years beginning after December 31, 1986 and before January 1, 1996, an environmental tax of 0.12% of the excess of AMTI (with certain modifications) over $2.0 million is imposed on corporations, including the Company, whether or not an Alternative Minimum Tax ("AMT") is paid. The Bank does not expect to be subject to the AMT, but may be subject to the environmental tax liability.

Dividends Received Deduction and Other Matters. The Company may exclude from its income 100% of dividends received from the Bank as a member of the same affiliated group of corporations. The corporate dividends received deduction is generally 70% in the case of dividends received from unaffiliated corporations with which the Company and the Bank will not file a consolidated tax return, except that if the Company or the Bank own more than 20% of the stock of a corporation distributing a dividend then 80% of any dividends received may be deducted.

State and Local Taxation

State of California. The California franchise tax rate applicable to the Bank equals the franchise tax rate applicable to corporations generally, plus an "in lieu" rate approximately equal to personal property taxes and business license taxes paid by such corporations (but not generally paid by banks or financial corporations such as the Bank); however, the total tax rate cannot exceed 10.84%. Under California regulations, bad debt deductions are available in computing California franchise taxes using a three or six year weighted average loss experience method. The Bank and its California subsidiary file California State franchise tax returns on a combined basis. The Company, as a savings and loan holding company commercially domiciled in California, is treated as a financial corporation and subject to the general corporate tax rate plus the "in lieu" rate as discussed previously for the Bank.

Please refer to Note 13 to the Consolidated Financial Statements for additional information regarding income taxes.

Delaware Taxation. As a Delaware holding company not earning income in Delaware, the Company is exempted from Delaware corporate income tax but is required to file an annual report with and pay an annual franchise tax to the State of Delaware.

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Additional Item. Executive Officers of the Registrant

The following table sets forth certain information with respect to each executive officer of the Company or Bank who is not also a director of the Company. The Board of Directors appoints or reaffirms the appointment of all of the Company's executive officers each year. Each executive officer serves until the following year or until a respective successor is appointed.

Name	Age At 12/31/01	Position(s) With Company And / or Bank	Date Started In Position	Previous Experience Than Five Years In C
Carlene F. Anderson	49	Assistant Corporate Secretary Monterey Bay Bancorp, Inc.	6/11/99	Corporate Secretary Monterey Bay Bancorp 1994 - 1999
		Assistant Corporate Secretary Vice President, Compliance Monterey Bay Bank.	6/11/99 8/15/98	Corporate Secretary Monterey Bay Bank 1994 - 1999
Mark R. Andino	42	Chief Financial Officer Treasurer Monterey Bay Bancorp, Inc.	1/26/00	Treasurer Chela Financial 1999
		Senior Vice President Chief Financial Officer Treasurer Monterey Bay Bank	1/26/00	Senior Vice Presiden Chief Financial Offi HF Bancorp, Inc. Hemet Federal 1996 - 1999
Susan M. Carlson	49	Senior Vice President Chief Administrative Officer Monterey Bay Bank	6/28/01	Principal C&S Carlson Enterpri Financial Institutio 1996 - 2001 Vice President Director of Marketin American Bank, NA 1981 - 1996
Mary Anne Carson	34	Corporate Secretary Monterey Bay Bancorp, Inc.	5/9/01	Vice President Assistant To The Pre Coast Commercial Ban 1996 - 2001
		Corporate Secretary Vice President Director Of Community Relations Monterey Bay Bank	5/9/01	
David E. Porter	52	Senior Vice President Director of Commercial	10/30/00	Executive Vice Presi Chief Credit Officer

		Banking Monterey Bay Bank		Southern Pacific Ban 1996 - 2000
Ben A. Tinkey	49	Senior Vice President Chief Loan Officer Director of Real Estate Lending Monterey Bay Bank	9/20/94	

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Item 2. Properties.

The following table sets forth information relating to each of the Company's offices and stand alone ATM locations as of December 31, 2001:

Location	Lease Or Owned	Original Date Leased or Acquired	Date of Lease Expiration
Administrative Offices:			
15 Brennan Street Watsonville, California 95076	Owned	12-31-65	N/A
567 Auto Center Drive Watsonville, California 95076	Owned	03-23-98	N/A
Full Service Branch Offices:			
35 East Lake Avenue Watsonville, California 95076	Owned	12-31-65	N/A
805 First Street Gilroy, California 95020	Owned	12-01-76	N/A
1400 Munras Avenue Monterey, California 93940	Owned	07-07-93	N/A
1890 North Main Street Salinas, California 93906	Owned	07-07-93	N/A
1127 South Main Street Salinas, California 93901	Leased	08-08-93	06-30-05
8071 San Miguel Canyon Road Prunedale, California 93907	Leased	12-24-93	12-31-03
601 Bay Avenue Capitola, California 95020	Owned	12-10-96	N/A
6265 Highway 9 Felton, California 95018	Leased	05-01-98	04-30-03
Effective February 2002			
Loan Production Office:			

6080 Center Drive 6th Floor Los Angeles, CA. 90045	Leased	02-01-02	Month To Month

Stand Alone ATM's:	Agreement Commencement	Agreement Expiration
601 Wave Street Monterey, California 93940	4/11/00	4/10/03
104 Stockton Street Capitola, California 95010	9/1/97	8/31/02

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Item 3. Legal Proceedings.

From time to time, the Company is party to claims and legal proceedings in the ordinary course of business. Management believes that the ultimate aggregate liability represented thereby, if any, will not have a material adverse effect on the Company's consolidated financial position or results of operations.

Item 4. Submission of Matters to a Vote of Security Holders.

No matter was submitted during the quarter ended December 31, 2001 to a vote of Monterey Bay Bancorp, Inc.'s security holders through the solicitation of proxies or otherwise.

PART II

Item 5. Market for Registrant's Common Equity and Related Stockholder Matters.

The Common Stock of Monterey Bay Bancorp, Inc. is traded on the NASDAQ National Market under the symbol "MBBC." The stock commenced trading on February 15, 1995, when the Company went public and sold 4,492,085 shares at a price of $6.40 per share (adjusted for a 5:4 stock split on July 31, 1998).

As of March 20, 2002, there were 3,483,718 shares of the Company's common stock outstanding. As of February 28, 2002, there were 289 stockholders of record, not including persons or entities who hold their stock in nominee or "street" name.

The following table sets forth the high and the low daily closing prices of the Company's common stock for each of the following calendar quarters.

	High	Low
Year Ended December 31, 2001:		
Fourth quarter	$ 15.500	$ 12.750
Third quarter	$ 16.500	$ 11.400
Second quarter	$ 11.970	$ 9.750
First quarter	$ 11.875	$ 10.000

Year Ended December 31, 2000:

Fourth quarter	$ 10.750	$ 9.125
Third quarter	$ 10.000	$ 8.250
Second quarter	$ 9.375	$ 7.813
First quarter	$ 10.625	$ 7.875

The Company paid no cash dividends in 2001. The Board of Directors has indefinitely suspended the declaration and payment of cash dividends in favor of alternative uses for the Company's capital and liquidity. The Company declared and paid a cash dividend of $0.08 per share during 2000.

The Company is subject to certain restrictions and limitations on the payment of dividends pursuant to existing and applicable laws and regulations (see "Item 1. Business - Regulation And Supervision - Limitation On Capital Distributions" and Note 14 to the Consolidated Financial Statements).

Item 6. Selected Financial Data.

Set forth below are selected consolidated financial and other data of the Company for the periods and the dates indicated. This financial data is derived in part from, and should be read in conjunction with, the Consolidated Financial Statements and related Notes of the Company presented elsewhere herein. All per share information has been adjusted to reflect a five for four stock split paid to stockholders of record in July 1998.

	At December 31,		
	2001	2000	1999
			(Dollars In T
Selected Financial Condition Data:			
Total assets	$ 537,391	$ 486,190	$ 462,827
Investment securities available for sale	7,300	7,360	11,463
Investment securities held to maturity	--	--	--
Mortgage backed securities available for sale	30,644	42,950	57,716
Mortgage backed securities held to maturity	--	--	60
Loans receivable held for investment, net	465,887	391,820	360,686
Loans held for sale	713	--	--
Allowance for loan losses	6,665	5,364	3,502
Deposits	432,339	407,788	367,402
FHLB advances	53,582	32,582	49,582
Securities sold under agreements to repurchase	--	--	2,410
Stockholders' equity	50,162	43,837	40,803
Non-performing loans	2,252	4,741	8,182
Real estate acquired by foreclosure, net	--	--	96

	For The Year Ended Decembe		
	2001	2000	1999
			(Dollars In Thousands

Selected Operating Data:			
Interest and dividend income	$ 38,731	$ 37,757	$ 33,417
Interest expense	18,990	19,777	17,388
Net interest income before provision for loan losses	19,741	17,980	16,029
Provision for loan losses	1,400	2,175	835
Net interest income after provision for loan losses	18,341	15,805	15,194
Non-interest income	2,566	2,340	2,505
Non-interest expense	14,369	13,676	11,887
Income before provision for income taxes	6,538	4,469	5,812
Provision for income taxes	2,787	1,946	2,511
Net income	$ 3,751	$ 2,523	$ 3,301
Shares applicable to basic earnings per share	3,275,303	3,110,910	3,231,162
Basic earnings per share	$ 1.15	$ 0.81	$ 1.02
Shares applicable to diluted earnings per share	3,343,233	3,123,552	3,320,178
Diluted earnings per share	$ 1.12	$ 0.81	$ 0.99
Cash dividends per share	$ --	$ 0.08	$ 0.15

	At Or For The Year Ended Dece		
	2001	2000	1999
Selected Financial Ratios and Other Data (1):			
Performance Ratios			
Return on average assets (2)	0.73%	0.53%	0.73%
Return on average stockholders' equity (3)	7.94%	6.24%	8.05%
Average stockholders' equity to average assets	9.16%	8.52%	9.04%
Stockholders' equity to total assets at end of period	9.33%	9.02%	8.82%
Interest rate spread during the period (4)	3.67%	3.54%	3.27%
Net interest margin (5)	4.04%	3.96%	3.69%
Interest rate margin on average total assets (6)	3.83%	3.79%	3.53%
Average interest-earning assets / average interest-bearing liabilities	109.44%	109.62%	110.61%
Non-interest expense / average total assets	2.79%	2.88%	2.62%
Efficiency ratio (7)	64.41%	67.30%	64.14%
Regulatory Capital Ratios (8)			
Tangible capital	8.24%	8.03%	7.11%
Core capital	8.24%	8.03%	7.11%
Tier one risk based capital	11.38%	11.03%	9.58%
Total risk based capital	12.64%	12.28%	10.56%

Asset Quality Ratios			
Non-performing loans / gross loans receivable (9)	0.48%	1.19%	2.25%
Non-performing assets / total assets (10)	0.42%	0.98%	1.79%
Net charge-offs / average gross loans receivable	0.02%	0.08%	0.03%
Allowance for loan losses / gross loans receivable (9)	1.41%	1.35%	0.96%
Allowance for loan losses / non-performing loans	295.96%	113.14%	42.80%
Allowance for total estimated losses / non-performing assets	295.96%	113.14%	42.30%
Other Data			
Number of full-service customer facilities	8	8	8
Number of ATM's	11	11	10

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(1) Regulatory Capital Ratios and Asset Quality Ratios are end of period ratios. With the exception of end of period ratios, all ratios are based on average daily balances during the indicated periods.
(2) Return on average assets is net income divided by average total assets.
(3) Return on average stockholders' equity is net income divided by average stockholders' equity.
(4) Interest rate spread during the period represents the difference between the weighted average yield on interest-earning assets and the weighted average cost of interest-bearing liabilities.
(5) Net interest margin equals net interest income as a percent of average interest-earning assets.
(6) Interest rate margin on average total assets equals net interest income as a percent of average total assets.
(7) The efficiency ratio is calculated by dividing non-interest expense by the sum of net interest income and non-interest income. The efficiency ratio measures how much in expense the Company invests in order to generate each dollar of net revenue.
(8) Regulatory capital ratios are defined in Item 1. - "Business - Supervision And Regulation - Regulatory Capital Requirements And Capital Categories."
(9) Gross loans receivable includes loans held for investment and loans held for sale, less undisbursed loan funds and unamortized yield adjustments.
(10) Non-performing assets includes all nonperforming loans (nonaccrual loans and restructured loans) and real estate acquired via foreclosure or by acceptance of a deed in lieu of foreclosure.

Item 7. Management's Discussion And Analysis Of Financial Condition And Results Of Operations.

The following discussion and analysis should be read in conjunction with the Company's Consolidated Financial Statements and Notes to the Consolidated Financial Statements presented elsewhere in this Annual Report. Certain matters discussed or incorporated by reference in this Annual Report including, but not limited to, matters described in this Item 7., are forward looking statements that are subject to risks and uncertainties that could cause actual results to differ materially from those projected or implied in such statements.

General

The Company's primary business is providing financial services to individuals and businesses. The Company is headquartered in Watsonville, California, along the Central Coast. The Bank's history dates to 1925.

The Company pursues its business through conveniently located branch offices, where it attracts checking, money market, savings, and certificate of deposit accounts. These deposits, and other available funds, are invested in a variety of loans and securities. The vast majority of the Company's loans at December 31, 2001 were secured by various types of real estate. The Bank's deposit gathering and lending markets are concentrated in the communities surrounding its eight full service branch offices located in Santa Cruz, northern Monterey, and southern Santa Clara Counties, in California. The Company also conducts its business by a variety of electronic means, including Internet banking, telephone banking, and automated teller machine ("ATM") networks.

The most significant component of the Company's revenue is net interest income. Net interest income is the difference between interest and dividend income, primarily from loans, mortgage backed securities, and investment securities, and interest expense, primarily on deposits and borrowings. The Company's net interest income and net interest margin, which is defined as net interest income as a percent of average interest-earning assets, are affected by its asset growth and quality, its asset and liability composition, and the general interest rate environment.

The Company's service charges on deposits, mortgage loan servicing fees, and commissions from the sale of non-FDIC insured insurance products and investments through Portola also have significant effects on the Company's results of operations. An additional major factor in determining the Company's results of operations are non-interest expenses, which consist primarily of employee compensation, occupancy and equipment expenses, data and item processing fees, and other operating expenses. The Company's results of operations are also significantly affected by the level of provisions for loan losses and general economic and competitive conditions, particularly absolute and relative levels and changes in market interest rates, government policies, and actions of regulatory agencies.

As discussed under "Item 1. Business - Company Strategy", the Company is in the process of transforming itself from a savings & loan association that was historically focused upon funding residential mortgage loans with certificates of deposit into a community based commercial bank offering a far wider scope of financial services to individuals and businesses. This transformation is being undertaken to enhance stockholder value while at the same time better meeting the financial needs of the individuals, families, professionals, and businesses in the Greater Monterey Bay Area of Central California. This transformation presents significant execution risk, as the strategic profile being pursued by the Company requires much greater human and technological resources to accomplish than the Company's historical operations. In addition, community commercial banking is by nature a higher risk activity than traditional savings & loan business, with increased credit and operational risks, among other risk factors.

Activities Not Conducted By The Company

At December 31, 2001, the Company did not have:

o foreign currency risk, as all of the Company's operations are conducted in US dollars

- interest rate swap, cap, floor, or collar agreements; or other freestanding or embedded derivatives

- off balance sheet activity other than normal commitments to fund loans and lines of credit

- special purpose entities

- debt securities convertible into equity

In conjunction with its interest rate risk management program, the Company may, however, in the future enter into interest rate swap, cap, floor, collar, or similar arrangements. In addition, the Company may pursue different types and sources of capital in the future to support its growth, including trust preferred securities or convertible securities.

Primary Risks Experienced By The Company

The greatest single source of risk to the Company is credit risk. Credit risk is the financial exposure to borrowers' not repaying the loans extended by the Company. Other significant risks experienced by the Company are interest rate risk and operational risk. Interest rate risk is the financial exposure resulting from changes in nominal and relative interest rates, as more fully discussed under "Item 7a. Quantitative and Qualitative Disclosure of Market Risk". Operational risk results from the Company's funds transfer and related activities, whereby the Company could experience loss if funds were inappropriately transferred and not recovered. The Company maintains extensive policies and procedures and certain insurance policies designed to mitigate these primary risks. However, no set of practices can eliminate every potential current and future source of these risks. In addition, the Company creates economic value and earns income in part through the effective management, but not elimination, of these primary risks.

Critical Accounting Policies

The Company's financial statements are prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP"). The Company's significant accounting policies are presented in Note 1 to the Consolidated Financial Statements, which are included in this Annual Report. The Company follows accounting policies typical to the community commercial banking industry and in compliance with various regulations and guidelines as established by the Financial Accounting Standards Board ("FASB") and the Bank's primary federal regulator, the OTS.

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The Company's most significant management accounting estimate is the appropriate level for the allowance for loan losses. As discussed under "Item 1. Business - Credit Quality - Allowance For Loan Losses", the Company follows a methodology for calculating the appropriate level for the allowance for loan losses. However, various factors, many of which are beyond the control of the Company, could lead to significant revisions in the amount of allowance for loan losses in future periods, with a corresponding impact upon the results of operations. In addition, the calculation of the allowance for loan losses is by nature inexact, as the allowance represents Management's best estimate of the loan losses inherent in the Company's credit portfolios at the reporting date. These loan losses will occur in the future, and as such cannot be determined with absolute certainty at the reporting date.

Other estimates that the Company utilizes in its accounting include the expected useful lives of depreciable assets, such as buildings, building improvements, equipment, and furniture. The useful lives of various technology related hardware and software can be subject to change due to advances in technology and the general adoption of new standards for technology or interfaces among computer or telecommunication systems.

The Company applies Accounting Principles Board ("APB") Opinion No. 25 and related interpretations in accounting for stock options. Under APB No. 25, compensation cost for stock options is measured as the excess, if any, of the fair market value of the Company's stock at the date of grant over the amount the employee or director must pay to acquire the stock. Because the Company's stock option Plans provide for the issuance of options at a price of no less than the fair market value at the date of grant, no compensation cost is required to be recognized for the stock option Plans.

Had compensation costs for the stock option Plans been determined based upon the fair value at the date of grant consistent with SFAS No. 123, "Accounting For Stock Based Compensation", the Company's net income and earnings per share would have been reduced as disclosed in Note 18 to the Consolidated Financial Statements, based upon the assumptions listed therein.

GAAP itself may change over time, impacting the reporting of the Company's financial activity. Although the economic substance of the Company's transactions would not change, alterations in GAAP could affect the timing or manner of accounting or reporting.

Interest Rate Environment

The table below presents an overview of the interest rate environment during the two years ended December 31, 2001. During the first half of 2000, the Federal Reserve continued the series of interest rate increases it commenced in mid-1999, with the final rate increase implemented in May 2000. These increases were implemented by the Federal Reserve in response to strong economic growth and tight labor markets, among other factors. The Federal Reserve did not adjust its benchmark interest rates (including the target rate for overnight federal funds) again until January 2001. In January 2001, the Federal Reserve commenced what would become a historically large and rapid decrease in interest rates, as the economy slowed and eventually fell into recession. During 2001, the Federal Reserve cut interest rates a total of 11 times for an aggregate decrease of 475 basis points. By the end of 2001, short term interest rates were at low nominal levels that had not been seen for decades.

While the Federal Reserve took no formal rate adjustment action between June 2000 and December 2000, the capital markets did reflect the changing economic environment. Many capital markets interest rates, such as the London InterBank Offer Rate ("LIBOR") curve, peaked about May, 2000, and then commenced a gradual decline throughout the remainder of the year. For example, the one year LIBOR rate at May 31, 2000 was 7.50%, declining to 6.00% by December 31, 2000.

The Treasury yield curve shifted from a more traditional positively sloped curve at the beginning of 2000 to significantly negatively sloped curve by the end of the year. Inverted yield curves often present challenges to financial institutions, as short term funding rates can be higher than longer term investment rates. By mid 2001, the Treasury yield curve had returned to its more traditional positive slope. By the end of 2001, the Treasury yield was the steepest in the past two years, with a 333 basis point differential between the three month and ten year Treasury instruments. Steep, positively sloped yield curves are generally favorable for financial institutions, including the Company, as near term cash flows from intermediate to longer term higher yielding assets can be funded at comparatively low interest rates.

The past two years thus represented a period of substantial interest rate volatility, with significant changes in the nominal and relative levels of interest rates. This magnitude of interest rate volatility presents additional challenges to financial institutions, including the Company, in managing cash flows and interest rate risk exposure.

The 11th District Cost Of Funds Index ("COFI") and the 12 MTA Index ("12 MTA" - the 12 month cumulative average of the 1 year Treasury Constant Maturities Index or "1 Year CMT") are by nature lagging indices that trail changes in more responsive interest rate indices such as those associated with the spot Treasury or LIBOR markets.

Index/ Rate (1)	12/31/99	3/31/00	6/30/00	9/30/00	12/31/00	3/31/01	6/30/01
3 month Treasury bill	5.31%	5.87%	5.85%	6.20%	5.89%	4.28%	3.65%
6 month Treasury bill	5.73%	6.14%	6.22%	6.27%	5.70%	4.13%	3.64%
2 year Treasury note	6.24%	6.47%	6.36%	5.97%	5.09%	4.18%	4.24%
5 year Treasury note	6.34%	6.31%	6.18%	5.85%	4.97%	4.56%	4.95%
10 year Treasury note	6.44%	6.00%	6.03%	5.80%	5.11%	4.92%	5.41%
Target federal funds	5.50%	6.00%	6.50%	6.50%	6.50%	5.00%	3.75%
Prime rate	8.50%	9.00%	9.50%	9.50%	9.50%	8.00%	6.75%
3 month LIBOR	6.00%	6.29%	6.77%	6.81%	6.40%	4.88%	3.84%
12 month LIBOR	6.50%	6.94%	7.18%	6.80%	6.00%	4.67%	4.18%
1 Year CMT (2)	5.84%	6.22%	6.17%	6.13%	5.60%	4.30%	3.58%
12 MTA (2)	5.08%	5.46%	5.79%	6.04%	6.11%	5.71%	5.10%
COFI (2)	4.85%	5.00%	5.36%	5.55%	5.62%	5.20%	4.50%

(1) Indices / rates are spot values unless otherwise noted.
(2) These indices / rates are monthly averages.

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Business Strategy

The Company's overall business objective is to maximize stockholder value. The Company's Directors and Management believe that the best approach to achieving that key objective is to continue the Company's strategic transformation from a traditional savings & loan into a community commercial bank offering a broader range of financial services, products, and solutions to individuals and businesses in California. The Company's Directors and Management also believe that following a relationship focused approach to helping customers attain their financial goals progresses the Company toward its key strategic objective while also improving the quality of life in the communities served by the Company and making the Company a desirable employer. The Company's business strategy thus integrates advancing the interests of its three key constituencies: stockholders, local communities, and employees.

Specific elements of the Company's business strategy include:

o Increasing the ratio of loans to assets as a means of enhancing net interest income, serving more customers, moderating exposure to changes in interest rates, and better utilizing the Company's capital resources.

- Diversifying the product mix within the loan portfolio to reduce the high concentration in residential mortgages while also meeting the financing needs of consumers and businesses within the Company's market areas.

- Enhancing the delivery of relationship banking, where the Company's employees invest time and resources in thoroughly understanding their customers and thereby provide a comprehensive financial services solution.

- Expanding services for businesses, including improved deposit courier service, Internet business banking, funds sweep, and cash management products.

- Acquiring customers disaffected by the acquisition of their financial services provider or branch office.

- Capitalizing on the Company's position as one of the largest independent financial institutions in the Greater Monterey Bay Area and on the Bank's 76 year history.

- Bolstering non-interest income as a percent of total revenues, with such non-interest income sourced from an expanding list of fee based products and services, including ATM surcharges, deposit account and branch service charges, and sales of non-FDIC insured investment products including mutual funds and annuities.

- Changing the Company's deposit mix to emphasize transaction accounts as a means of cementing customer relationships, lowering the Company's relative cost of funds, generating fee income, and increasing the duration of the Company's funding.

- Capitalizing on business opportunities unique to the Company's primary service areas; for example, installing remote ATM's at highly trafficked tourist attractions.

- Pursuing alternative forms of delivery and new technologies for financial products and services as a means of attracting a greater volume of business while also improving the Company's efficiency ratio.

- Adding additional branch or loan production office facilities to better and more completely serve the Company's key market areas.

- Increasing the Company's visibility in and contributions to its local communities through the donation of equipment, funds, and employee time to a wide range of organizations committed to improving the quality of life in the Greater Monterey Bay Area.

For additional information regarding the Company's strategy, please see "Item 1. Business - Company Strategy".

The Company intends to continue pursuing this business strategy in 2002, with specific goals of adding a Southern California loan production office (opened in February, 2002), seeking sites for a de novo retail branch or opportunities for the acquisition of existing bank branches, expanding the Commercial Banking group, increasing customer use of Internet banking and electronic bill payment, pursuing additional remote ATM sites, implementing new technologies complementary to the new core data processing system installed in

2001, and effectively managing the Company's strong capital position. However, there can be no assurance that any such steps will be implemented, or if implemented, whether such steps will improve the Company's financial performance.

Analysis Of Results Of Operations For The Years Ended December 31, 2001 And December 31, 2000

Overview

For the year ended December 31, 2001, net income was $3.75 million, equivalent to $1.15 basic earnings per share and $1.12 diluted earnings per share. This compares to net income of $2.52 million, or $0.81 basic and diluted earnings per share, for the year 2000. The $3.75 million in 2001 net income was the highest annual level in the Company's history. Return on average stockholders' equity increased from 6.24% in 2000 to 7.94% in 2001. Return on average assets increased from 0.53% in 2000 to 0.73% in 2001.

The Company's financial performance increased sequentially from the first quarter of 2001 through to the fourth quarter, which represented the highest quarterly earnings in the Company's history. The continued implementation of the Company's strategic plan was a primary factor in the Company's improved financial performance in 2001 versus 2000. Other factors included a more favorable credit experience in 2001 versus 2000, and better results on the sale of securities.

Net Interest Income

Net interest income increased from $18.0 million in 2000 to $19.7 million in 2001 due to both expanded spreads and greater average balances of interest earnings assets. The Company's ratio of net interest income to average total assets increased from 3.79% in 2000 to 3.83% in 2001 despite the Company's difficulty in decreasing NOW and Savings deposit rates at the same pace as the declines in indices used for adjustable rate loans. The Company's NOW and Savings deposit rates were already at low nominal levels before the significant interest rate cuts (totaling 475 basis points) implemented by the Federal Reserve throughout 2001. The Company moderated the impact of these factors in 2001 through its proactive asset / liability management program and a shift in balance sheet composition.

The Company's ratio of net interest income to average total assets rose to 3.92% during the fourth quarter of 2001, as the new commercial banking customers attracted during 2001 commenced having a more significant, positive impact upon the Company's spreads.

The expansion in the Company's net interest margin on average interest earning assets from 3.69% in 1999 to 3.96% in 2000 to 4.04% in 2001 constitutes a key trend in the Company's financial performance. This trend has resulted from the actions taken by the Company coincident with its strategic plan.

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The $1.7 million, or 9.8%, increase in net interest income generated in 2001 versus 2000 primarily resulted from four factors:

1. Change In Asset Mix

Average net loans receivable increased from 80.0% of average total assets in 2000 to 83.8% of average total assets in 2001. Lower yielding cash equivalents, investment securities, and mortgage backed securities all declined as a percentage of average total assets in 2001 versus 2000. The benefits from this shift in asset mix were significant, as the average rate earned on net loans receivable in 2001 was 8.21%, substantially above the 4.13% earned on cash equivalents, 5.55% earned on investment securities, and 6.08% earned on mortgage backed securities.

2. Change in Liability Mix

Average transaction deposit accounts (DDA, NOW, Savings, and Money Market combined) as a percentage of average total deposits rose from 40.5% in 2000 to 41.1% in 2001. Transaction deposit accounts present a lower cost of funding than most alternative sources. Non-interest bearing demand deposit accounts ("DDA") rose from 4.3% of average total deposits in 2000 to 4.6% in 2001. The Company has targeted increased DDA balances, particularly from business customers, as an important component of its business strategy.

3. Increased Average Balance Sheet

Average total assets increased by 8.6% from 2000 to 2001. The larger average balances of interest earning assets and interest bearing liabilities, combined with expanding spreads, contributed toward greater nominal net interest income.

4. Asset / Liability Management

Net interest income in 2001 benefited from positions taken by the Company as a result of its asset / liability management program, as more fully discussed under "Item 7a. Quantitative and Qualitative Disclosure of Market Risk". Early in 2001, the Company moderately increased the net liability sensitivity of the balance sheet in order to benefit from the rapid and significant interest rate cuts being implemented by the Federal Reserve. This was accomplished, in part, by adding intermediate term, fixed rate assets during the first half of the year, primarily in the form of residential hybrid mortgages.

Net interest income was also benefited in 2001 versus 2000 by an increase in average stockholders' equity, which was substantially offset by an increase in average non-interest earning assets, primarily deferred tax assets. As presented in Note 13 to the Consolidated Financial Statements, net deferred tax assets increased in 2001 primarily due to the rise in the Company allowance for loan losses and because of the differential between book and tax amortization periods for core deposit intangibles.

In conjunction with its business strategy, the Company plans to expand net interest income in future periods by:

- continuing to increase the percentage of its assets allocated to loans
- shifting the loan mix toward higher yielding types of loans and away from comparatively lower yielding residential mortgages
- raising the percentage of its total deposits represented by transaction accounts and decreasing the percentage of total deposits represented by certificates of deposit
- increasing the volume of interest earning assets
- continuing to proactively manage the Company's exposure to changes in the nominal and relative levels of general market interest rates

Average Balances, Average Rates, And Net Interest Margin

The following table presents the average amounts outstanding for the major categories of the Company's assets and liabilities, the average rate earned upon each major category of interest earning assets, the average rate paid for each major category of interest bearing liabilities, and the resulting net interest spread, net interest margin, and average interest margin on total assets for the years indicated.

	Year Ended December 31, 2001			Year Ended December 31, 200		
	Average Balance	Interest	Avg. Rate	Average Balance	Interest	Av Ra
				(Dollars In Thousands)		
Assets						
Interest earning assets:						
Cash equivalents (1)	$ 7,598	$ 314	4.13%	$ 8,533	$ 540	6.3
Investment securities (2)	7,318	406	5.55%	8,915	689	7.7
Mortgage backed securities (3)	38,795	2,360	6.08%	53,822	3,755	6.9
Loans receivable, net (4)	432,020	35,485	8.21%	379,823	32,556	8.5
FHLB stock	3,065	166	5.42%	3,003	217	7.2
Total interest earning assets	488,796	38,731	7.92%	454,096	37,757	8.3
Non-interest earnings assets	26,555			20,391		
Total assets	$515,351			$474,487		
Liabilities & Equity						
Interest bearing liabilities:						
NOW accounts	$40,944	366	0.89%	$ 36,317	550	1.5
Savings accounts	19,370	216	1.12%	15,803	281	1.7
Money market accounts	92,237	3,452	3.74%	87,733	4,040	4.6
Certificates of deposit	246,315	12,415	5.04%	230,099	12,360	5.3
Total interest-bearing deposits	398,866	16,449	4.12%	369,952	17,231	4.6
FHLB advances	47,526	2,518	5.30%	43,946	2,514	5.7
Other borrowings (5)	244	23	9.43%	359	32	8.9
Total interest-bearing	446,636	18,990	4.25%	414,257	19,777	4.7
liabilities						
Demand deposit accounts	19,104			16,720		
Other non-interest bearing liabilities	2,396			3,104		
Total liabilities	468,136			434,081		
Stockholders' equity	47,215			40,406		
Total liabilities & equity	$515,351			$474,487		
Net interest income		$19,741			$17,980	

Interest rate spread (6)			3.67%		3.5
Net interest earning assets	42,160			39,839	
Net interest margin (7)		4.04%			3.96%
Net interest income / average total assets		3.83%			3.79%
Interest earnings assets / interest bearing liabilities	1.09			1.10	

Average balances in the above table were calculated using average daily figures. Interest income is reflected on an actual basis, as the Company maintained no tax preferenced securities during the periods reported.

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(1) Includes federal funds sold, money market fund investments, banker's acceptances, commercial paper, interest earning deposit accounts, and securities purchased under agreements to resell.
(2) Includes investment securities both available for sale and held to maturity.
(3) Includes mortgage backed securities, including CMOs, both available for sale and held to maturity.
(4) In computing the average balance of loans receivable, non-accrual loans and loans held for sale have been included. Amount is net of deferred loan fees, premiums and discounts, undisbursed loan funds, and allowances for loan losses. Interest income on loans includes amortized loan fees and costs, net, of $223,000, $250,000, and $293,000 in 2001, 2000, and 1999, respectively.
(5) Includes federal funds purchased, securities sold under agreements to repurchase, and borrowings under MBBC's line of credit.
(6) Interest rate spread represents the difference between the average rate on interest earning assets and the average rate on interest bearing liabilities.
(7) Net interest margin equals net interest income before provision for estimated loan losses divided by average interest earning assets.

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Rate/Volume Analysis

The most significant impact on the Company's net interest income between periods is derived from the interaction of changes in the volumes of and rates earned or paid on interest-earning assets and interest-bearing liabilities. The following table utilizes the figures from the preceding table to present a comparison of interest income and interest expense resulting from changes in the volumes and the rates on average interest earning assets and average interest bearing liabilities for the years indicated. Changes in interest income or interest expense attributable to volume changes are calculated by multiplying the change in volume by the prior year average interest rate. The changes in interest income or interest expense attributable to interest rate changes are calculated by multiplying the change in interest rate by the prior year average volume. The changes in interest income or interest expense attributable to the combined impact of changes in volume and changes in interest rate are calculated by multiplying the change in rate by the change in volume.

Year Ended December 31, 2001 Yea

	Compared To Year Ended December 31, 2000 — Increase (Decrease) Due To Volume	Rate	Volume / Rate	Net	Yea[r] In[crease] Volume
				(Dollars In Thousands)	
Interest-earning assets					
Cash equivalents	$ (59)	$ (187)	$ 20	$ (226)	$ 129
Investment securities	(123)	(194)	34	(283)	(301)
Mortgage backed securities	(1,048)	(481)	134	(1,395)	(1,289)
Loans receivable, net	4,474	(1,358)	(187)	2,929	3,274
FHLB Stock	4	(54)	(1)	(51)	(7)
Total interest-earning assets	3,248	(2,274)	0	974	1,806
Interest-bearing liabilities					
NOW Accounts	70	(225)	(29)	$ (184)	171
Savings accounts	63	(105)	(23)	(65)	4
Money market accounts	207	(757)	(38)	(588)	238
Certificates of deposit	871	(762)	(54)	55	29
Total interest-bearing deposits	1,211	(1,849)	(144)	(782)	442
FHLB advances	205	(186)	(15)	4	351
Other borrowings	(10)	2	(1)	(9)	(159)
Total interest-bearing liabilities	1,406	(2,033)	(160)	(787)	634
Increase (decrease) in net interest income	$1,842	$ (241)	$ 160	$1,761	$1,172

Interest Income

Interest income for the year ended December 31, 2001 totaled $38.7 million, an increase of $0.9 million from $37.8 million in the prior year. This 2.6% increase resulted from the effects of greater average balances of interest earning assets and a shift in the earning asset mix more than offsetting the impact of a lower interest rate environment in 2001 versus 2000.

Interest income on loans increased 9.0% from $32.6 million in 2000 to $35.5 million in 2001, as the effect of greater average balances more than offset a decline in average rate from 8.57% in 2000 to 8.21% in 2001. Because the vast majority of the Company's loans are either adjustable rate or fixed rate for a limited period of time and then adjustable rate, the declining interest rate environment prevalent throughout 2001 reduced the Company's yield on its loan portfolio. The drop in this yield was, however, moderated by periodic caps and lifetime floors on certain loan products.

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Interest income on mortgage backed securities declined from $3.8 million in 2000 to $2.4 million in 2001 due to both lower average balances and reduced average rates. The reduction in average balances was intentional, as the

Company used scheduled principal payments, principal prepayments, and sales of mortgage backed securities to support the expansion in the loan portfolio and achieve the targeted shift in asset mix. The decline in average rates was caused by:

- a shift in the mix of mortgage backed securities away from long term, fixed rate pass-though certificates to lower duration collateralized mortgage obligations and adjustable rate pass through certificates in conjunction with the Company's asset / liability management program

- a shift in the mix of collateralized mortgage obligations away from Non Agency issued securities toward Agency issued securities in order to obtain greater liquidity and to increase the amount of securities eligible for use a collateral for various types of deposits

- the general decline in interest rates, as adjustable rate mortgage backed securities repriced downwards and as new security purchases during 2001 generally had lower effective rates than the securities in the portfolio at the end of 2000

Please refer to Note 4 to the Consolidated Financial Statements for additional information regarding mortgage backed securities.

Interest income on investment securities decreased from $689 thousand in 2000 to $406 thousand in 2001. This decline was due to lower average balances and lower average rates. Because all of the Company's investment securities in 2000 and 2001 were variable rate corporate trust preferred securities that adjust quarterly based upon the 3 Month LIBOR Index, these securities repriced downwards rapidly in 2001 in conjunction with the interest rate cuts implemented by the Federal Reserve. Please refer to Note 3 to the Consolidated Financial Statements for additional information regarding investment securities.

Interest income on cash equivalents declined from $540 thousand in 2000 to $314 thousand in 2001 due to both lower average balances and lower average rates. An objective of the Company is to minimize its cash & cash equivalent position, subject to ensuring the maintenance of sufficient liquidity, in order to allocate investable funds toward higher yielding types of assets. Because cash equivalents are of limited term, they repriced downward quickly in 2001.

Dividend income on FHLB stock decreased from $217 thousand in 2000 to $166 thousand in 2001 due to lower effective rates. The lower effective rates were due to the lower interest rate environment in 2001 versus 2000 and due to the FHLB-SF's decision to pay particularly high dividend rates during the first half of 2000 in conjunction with its capital management program.

Interest Expense

Interest expense for the year ended December 31, 2001 totaled $19.0 million, representing a decrease of $0.8 million, or 4.0%, from $19.8 million in the prior year. This decrease resulted from the change in the mix of interest bearing liabilities and the effect of lower average rates more than offsetting the impact of greater average balances of interest bearing liabilities.

Interest expense on interest bearing deposits decreased from $17.2 million in 2000 to $16.4 million in 2001, as the change in composition and the effect of lower effective rates more than offset the impact of greater average balances. The increased average balances were in conformity with the Company's strategic plan of increasing market share in its local communities and better meeting the savings, funds management, and investment needs of individuals and businesses in the Greater Monterey Bay Area. The lower average rates in 2001 versus 2000 resulted from the lower interest rate environment and a shift in deposit mix away from relatively higher cost certificates of deposit toward relatively lower cost transaction accounts. Certificates of deposit constituted 58.9% of average total deposits in 2001, compared to 59.5% the prior year. The weighted average cost of interest bearing deposits declined from 4.66% in 2000 to 4.12% in 2001. A rise in attractively priced funds in conjunction with the State of California Time Deposit program also contributed to the decrease in average deposit costs in 2001.

Interest expense on borrowings was nearly constant in 2000 and 2001, as the effect of an increase in average balances was offset by the impact of lower average rates. While the Company has access to various types of borrowings, most borrowings in 2001 were concentrated in FHLB advances. The various credit programs from the FHLB-SF provide the Company with the opportunity to undertake specific borrowings designed to meet current and projected funding needs while also facilitating the asset / liability management program. The average effective rate on borrowings other than FHLB advances was inflated in 2000 and 2001 by the amortization of the commitment fee associated with MBBC's line of credit from a correspondent bank.

Provision For Loan Losses

Implicit in lending activities is the risk that losses will occur and that the amount of such losses will vary over time. Consequently, the Company maintains an allowance for loan losses by charging a provision to operations. Loans determined to be losses are charged against the allowance for loan losses. The allowance for loan losses is maintained at a level considered by Management, at a point in time and with then available information, to be adequate to provide for estimable and probable losses inherent in the existing portfolio.

In evaluating the adequacy of the allowance for loan losses, Management estimates the amount of probable loss for each individual loan that has been identified as having greater than standard credit risk, including loans identified as criticized ("Special Mention"), classified ("Substandard" or lower graded), impaired, troubled debt restructured, and non-performing. In determining specific and formula loss estimates, Management incorporates such factors as collateral value, portfolio composition and concentration, trends in local and national economic and real estate conditions, the duration of the current business cycle, seasoning of the loan portfolio, historical credit experience, and the financial status of borrowers. While the overall allowance is segmented by broad portfolio categories to analyze its adequacy, the allowance is general in nature and is available for the loan portfolio in its entirety. Although Management believes that the allowance is adequate, future provisions are subject to continuing evaluation of inherent risk in the loan portfolio, as conducted by both Management and the Bank's regulators.

Provisions for loan losses declined from $2.2 million in 2000 to $1.4 million in 2001. The change in provisions was due to the result of the Company's methodology for calculating the level of allowance for loan losses. Factors that contributed to the reduction in provisions in 2001 versus the prior year included:

- a lower level of net charge-offs in 2001 versus 2000
- a decrease in the amount of classified loans at December 31, 2001 versus the prior year end
- a reduced concentration of relatively higher risk construction and land loans in 2001 versus 2000

- the reduction in specific reserves of $600 thousand associated with a commercial real estate construction loan that was collected in full during the second quarter of 2001

- an increased concentration of relatively lower risk residential and multifamily mortgages in 2001 versus 2000

The above factors more than offset the impact of a larger loan portfolio, including growth in commercial business loans outstanding, which increased from $3.1 million at December 31, 2000 to $8.8 million at December 31, 2001. The above factors also more than offset higher reserve factors for the Company's portfolios of hotel / motel real estate loans and Business Express loans (see "Item 1. Business - Credit Quality").

To the extent that the Company is successful in its business strategy and thereby continues building the size of its loan portfolio while also extending increased volumes of construction, income property, and business lending, Management anticipates that additional provisions will be required and charged against operations in 2002, with the ratio of allowance for loan losses to loans receivable increasing to reflect the greater credit exposure inherent in the loan mix.

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Non-Interest Income

Non-interest income totaled $2.6 million in 2001, comparing favorably to $2.3 million in 2000. The Company recorded $190 thousand in pre-tax gains on security sales in 2001, versus a pre-tax loss of $55 thousand during 2000. As discussed below, customer service charges and mortgage banking income also increased in 2001 versus the prior year, offset by reduced loan servicing income and decreased commissions from sales of non-FDIC insured investments.

Service charge income rose from $1.3 million during 2000 to $1.7 million during 2001. This increase primarily resulted from the revised fee and service charge schedule implemented with the new core processing system in 2001.

Loan servicing income totaled $101 thousand during 2001, compared to $118 thousand during 2000. The Company continues to sell the vast majority of its long term, fixed rate residential loan production into the secondary market on a servicing released basis. As a result, the portfolio of loans serviced for others is declining as loans pay off. At December 31, 2001, the Company serviced $42.6 million in various types of loans for other investors, compared to $62.0 million at December 31, 2000.

Commissions from sale of non-FDIC insured investments totaled $244 thousand during 2001, compared to $676 thousand during 2000. Less favorable general capital market conditions, the events of September 11, 2001, and investment staff turnover and vacancies contributed to the lower revenues in 2001 versus 2000. During early 2002, the Company continued to be challenged in recruiting licensed investment sales representatives.

Gains on the sale of loans increased from $23 thousand during 2000 to $88 thousand during 2001. The lower general interest rate environment in 2001 led to a strong residential loan refinance market, which in turn bolstered the Company's mortgage banking activity. In 2001, the Company implemented new technology designed to speed the processing, funding, and delivery into the secondary market of fixed rate residential mortgages, thus lower operating costs and providing enhanced customer service.

Further augmenting non-interest income, both nominally and a percentage of total revenue, constitutes a primary component of the Company's business strategy. In 2002, the Company plans to enhance its fee income by continuing to market electronic bill payment and debit card services, increasing the number of transaction deposit accounts, and selling depository and cash management services to business customers who would be charged via account analysis.

Non-Interest Expense

Non-interest expense rose $0.7 million, or 5.1%, from $13.7 million in 2000 to $14.4 million in 2001. Total non-interest expense in 2001 was increased by costs for the March 2001 data processing conversion ($447 thousand) and legal and other expenses associated with the arbitration of claims by a former executive ($284 thousand). Total non-interest expenses in 2000 included $108 thousand in costs for the data processing conversion and $250 thousand accrued for settlement of the claims by the former executive. Costs for the data processing conversion included de-conversion fees to the prior service bureau, printing and postage costs for additional customer communications, employee training and travel costs, and consulting fees for technology professionals retained to assist with and speed the implementation of the new system.

Throughout 2001, the Company adjusted its staffing to advance the strategic plan, primarily through the hiring of commercial loan officers and professional bankers. Staffing was also increased in the data processing function, coincident with the Company's shifting from an external service bureau to in-house data processing. The change in the Company's systems environment also impacted various other operating expenses. Data processing fees were much lower in 2001 versus 2000, while equipment expense was higher due to the added depreciation from the new hardware and software installed in 2001.

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Compensation and employee benefit costs also increased in 2001 versus 2000 for payments under certain incentive compensation plans. These expenses rose in 2001 in conjunction with the Company's improved financial performance. Costs for the Bank's employee stock ownership plan ("ESOP") increased in 2001 versus 2000 because of the higher average price of Monterey Bay Bancorp, Inc. common stock.

Advertising and promotion costs during 2001 were $249 thousand, down from $361 thousand in 2000 primarily due to the Company's reducing certain marketing efforts early in 2001 while the core processing conversion was being completed. Advertising during 2001 included local radio ads that focused on attracting business customers through the communication of the Bank's "relationship banking" approach to customer service. The Bank also continued to promote its 2001 theme of "Monterey Bay Bank. Expect More. Get The Best."

While the Company's efficiency ratio improved from 67.30% in 2000 to 64.41% in 2001, Management acknowledges that this ratio remains above levels produced by higher performing peer companies. This ratio has been unfavorably impacted during the past two years by the up front operating costs and other expenses that the Company has incurred in advance of associated revenues as the Company has implemented its strategic plan. The Company has made investments in new staff and new systems that are necessary to successfully market a broader range of financial products to a greater segment of individuals and businesses in its primary market areas. These investments by nature had to precede the associated revenues. By the fourth quarter of 2001, the financial benefits of these investments became more prominent, as the efficiency ratio during the fourth quarter of 2001 declined to 59.59%.

The Company plans to continue making investments to support its strategic plan in 2002; in particular, the hiring of additional business relationship officers, real estate loan originators, and professional bankers. However, these investments are likely to be of lesser relative magnitude that those conducted in 2000 and 2001. In addition, management has commenced a series of initiatives designed to both improve customer service and satisfaction while also improving profitability. These initiatives, planned for implementation in 2002, include:

- increasing emphasis on variable, performance based compensation, with measurement criteria directly related to financial contribution, economic value created, customer retention, and new customer development

- implementing technology complementary to the new core processing system installed in 2001 to improve productivity and enhance customer service

- using new technology to foster the re-allocation of employee time and costs from operational or administrative functions toward revenue generation and customer service

However, there can be no assurance that the Company will be successful in implementing the above initiatives or that the Company's will be able to improve its profitability or efficiency ratio.

Stock Based Compensation

In 2001, the Company extensively utilized stock based compensation for Directors, Officers, and a significant number of non-officer employees. The Company believes that the use of stock based compensation aligns Director, Officer, and employee interests with those of stockholders. The Company's stock based compensation programs are discussed in Note 18 to the Consolidated Financial Statements. Several of the Company's stock based compensation programs provide for vesting periods of up to five years, thereby also encouraging Management and employees to work in the best long term interests of the Company and its stockholders. Director retainer fees during 2001 were paid in Company common stock. In addition, a number of the Bank's Officers voluntarily accepted Company common stock in lieu of certain cash compensation during 2001. These decisions included the election by the Chief Executive Officer and Chief Financial Officer to each receive a significant component of his 2001 incentive compensation in Company common stock.

The Company intends to continue extensively utilizing stock based compensation and incentives in 2002, including the issuance of additional stock options, as approved by stockholders, at 110% of the fair market value of the stock on the date of grant. This compares to the 100% ratio generally prevalent among similar financial institution holding companies.

Provision For Income Taxes

The provision for income taxes increased from $1.9 million in 2000 to $2.8 million in 2001 due to a rise in pre-tax income. The Company's effective book tax rate decreased slightly in 2001 versus the prior year. The Company's effective book tax rate in recent years has been above the statutory rate due to the fair market value adjustment arising from the ESOP. The Company recognizes operating expense for the ESOP based upon fair market value at the date shares are committed to be released. The differential between fair market value and the Company's historical basis in the ESOP shares committed to be released comprises the fair market value adjustment that is added to pre-tax income in determining the Company's provision for income taxes.

Comparison Of Financial Condition At December 31, 2001 And December 31, 2000

Total assets of the Company were $537.4 million at December 31, 2001, compared to $486.2 million at December 31, 2000, an increase of $51.2 million, or 10.5%.

Cash & cash equivalents decreased from $25.2 million at December 31, 2000 to $13.1 million at December 31, 2001 due to the Company's using cash equivalents to fund an expansion in the loan portfolio.

Investment securities at December 31, 2000 and 2001 were composed of the same two variable rate corporate trust preferred securities issued by major US banks that reprice quarterly based upon a margin over the 3 month LIBOR rate. These two securities were rated "A-" or better by Standards & Poors rating agency at December 31, 2001. Management may consider selling these two securities in 2002 to bolster the Bank's QTL ratio, shift funds into assets that function as more effective collateral under secured borrowing arrangements, and provide funds for further expansion in loans receivable. Increasing the QTL ratio would provide additional time before the Bank would be forced by regulation to allocate the management time and incur the operating expense associated with a change in charter from a federal thrift to either a California State or national commercial bank. For additional information regarding investment securities, please refer to Note 3 to the Consolidated Financial Statements.

Mortgage backed securities decreased from $43.0 million at December 31, 2000 to $30.6 million at December 31, 2001. During 2001, the Company utilized cash flows from sales and principal payments on mortgage related securities to fund an increase in the loan portfolio. All of the Company's mortgage backed securities at December 31, 2001 were rated "AAA" by at least one nationally recognized ratings agency.

As highlighted in Note 4 to the Consolidated Financial Statements, during 2001, the Company also continued altering the mix of its mortgage backed securities. Long term, fixed rate pass-through securities were decreased, while variable rate and balloon mortgage backed securities were increased. CMO's were shifted to higher cash flow, shorter term securities with less extension risk. These instruments provide more periodic funds that can be used to support further expansion in net loans receivable. These changes were conducted in conjunction with the Company's asset / liability and liquidity management programs. In 2001, Management reallocated some of the Company's capacity for longer term, fixed rate assets from the security portfolio to the loan portfolio, where better yields were available for the same level of interest rate risk.

The Company also shifted the mix in CMO issuers in 2001 toward Agency issuance and away from private label, "AAA" rated securities. This alteration in mix was conducted to provide additional eligible collateral for various types of deposits, including time deposits placed by the State of California.

In 2002, the Company plans to continue emphasizing the use of CMO's in its mortgage backed security portfolio, as the Company can use certain CMO's (e.g. Planned Amortization Classes, or "PAC's") to target future cash flows in conjunction with its asset / liability, liquidity, and balance sheet management programs. The Company does, however, plan to purchase additional longer term, fixed rate mortgage backed securities in 2002 as part of its proactive efforts to increase investment in low to moderate income housing.

Loans held for sale, carried at the lower of cost or market, totaled $713 thousand at December 31, 2001. The Company sells most of its long term, fixed rate residential mortgage production into the secondary market on a servicing released basis, and purchases more interest rate sensitive loans as part of its interest rate risk management program.

Loans held for investment, net, increased from $391.8 million at December 31, 2000 to a record $465.9 million at December 31, 2001. The increase resulted from a combination of strong internal loan originations and from pool purchases of various types of California real estate loans. Net loans as a percentage of total assets increased from 80.6% at December 31, 2000 to 86.8% at December 31, 2001, in conjunction with the Company's strategy of supporting its interest margin, fostering economic activity in its local communities, and effectively utilizing the Bank's capital. Management has targeted increasing the net loan to asset ratio to 90.0% in 2002 should market conditions prove favorable.

In conjunction with its strategic plan, the Company intends to pursue both an expansion in net loans receivable in 2002 and a shift in loan mix away from residential mortgages toward income property, construction, and business lending. The establishment of the Los Angeles loan production office in the first quarter of 2002 is expected to advance that change in mix, as that office will focus on construction and income property lending.

While just 1.8% of gross loans outstanding at December 31, 2001, the Company's commercial business lending gained momentum during the fourth quarter of 2001, ending the year with a record loan pipeline. The new commercial banking relationship officers hired during 2001 had a positive impact in the fourth quarter of the year, generating a rise in deposit balances in addition to the expansion in the business loan portfolio.

The Company's investment in the capital stock of the FHLB increased from $2.9 million at December 31, 2000 to $3.0 million at December 31, 2001. Stock dividends and capital stock purchases during 2001 were partially offset by a mandatory capital stock redemption.

The Company's balance of premises and equipment, net, increased by $243 thousand in 2001 primarily due to hardware and software purchased in support of the new core processing system. Premises and equipment balances may increase more substantially in 2002 if the Company is successful in acquiring or opening de novo one or more new branch locations. For additional information regarding premises and equipment, please refer to Note 8 to the Consolidated Financial Statements.

The Company continued to amortize its core deposit intangibles during 2001, reducing their balance from $2.2 million at December 31, 2000 to $1.5 million at December 31, 2001. This amortization, which is a non-cash charge to operations, bolsters the Bank's regulatory capital ratios (all else held constant), as intangible assets are deducted from GAAP capital in determining regulatory capital. This amortization also increases the Company's tangible book value per share. For additional information regarding core deposit intangibles, please refer to Note 9 to the Consolidated Financial Statements.

At December 31, 2001, the Company maintained $75 thousand in originated mortgage servicing rights, down from $165 thousand a year earlier. Because the Company has adopted a program of generally selling its loans on a servicing released basis, Management anticipates that the balance of originated mortgage servicing rights will continue to decline as the existing portfolio of loans serviced for others pays off.

Total liabilities rose 10.1% from $442.4 million at December 31, 2000 to $487.2 million at December 31, 2001. This $44.8 million increase was approximately split between an increase in deposits and an increase in borrowings. Accounts payable and other liabilities decreased by $0.9 million during 2001 primarily due to the timing of interest payments on borrowings, a reduction in accrued liabilities for deferred compensation and non-qualified retirement plans, and the 2001 settlement of claims by a former executive which had been accrued at December 31, 2000. In 2002, the Company intends to pursue the conclusion of all non-qualified retirement plans through the negotiation of lump sum payments. Such conclusion accelerates tax deductions for the Company, saves a minor amount of administrative overhead, and reduces other liabilities. This conclusion is expected to have only a minor, if any, impact on the results of operations.

Deposits increased from $407.8 million at December 31, 2000 to a record $432.3 million at December 31, 2001. The Company experienced strong growth in money market deposits during 2001 due to a combination of sales and marketing focus and the historically low interest rate environment's leading certain customers to delay committing funds to term certificates of deposit. Deposit growth during 2001 was, however, restrained by a small number of very large competitors that conducted aggressive promotional campaigns based on paying interest rates significantly above levels offered by most money center, regional, and California community banks. Deposit growth during 2001 was also restrained by customer response to the new systems environment, as the Company eliminated passbooks in favor of statement accounts and as certain deposit products were repriced upwards to reflect competitive market conditions or the Company's costs of providing the accounts.

The Company continues to focus on attracting new transaction deposit accounts in conjunction with its strategic plan, with the additional objective of continuing to reduce the percentage of the deposit mix represented by relatively higher cost certificates of deposit. Certificates of deposit declined from 60.0% of total deposits at December 31, 2000 to 56.4% of total deposits at December 31, 2001, despite a $5.0 million increase in funds from the State of California Time Deposit Program. For additional information regarding deposits, please refer to Note 10 to the Consolidated Financial Statements.

FHLB advances increased from $32.6 million at December 31, 2000 to $53.6 million at December 31, 2001. During 2001, the Company utilized FHLB advances to fund some of the expansion in the loan portfolio. All of the Company's FHLB advances at December 31, 2001 were fixed rate, fixed term borrowings without call or put option features. During the fourth quarter of 2001, the Company prepaid $10.0 million in FHLB advances due in the first quarter of 2002 in order to extend the term structure of that debt in conjunction with the Company's asset / liability management program. Despite the Company's strong capital position in 2001, Management did not pursue extensive leveraging via wholesale assets and liabilities, such as FHLB advances. Management believes the Company's capital is better deployed in meeting the financial needs of individuals, families, and businesses, and that much lesser economic value is created by engaging in wholesale leveraging strategies.

Consolidated stockholders' equity increased from $43.8 million at December 31, 2000 to $50.2 million at December 31, 2001 due to a combination of:

o net income
o continued amortization of deferred stock compensation
o Directors receiving their fees in Company stock
o appreciation in the portfolio of securities classified as available for

sale, recorded in other comprehensive income
- the exercise of vested stock options

The Company did not declare or pay any cash dividends in 2001. In 2000, the Company announced the indefinite suspension of the declaration and payment of cash dividends. The Board of Directors believes that, at this time, the Company's capital is better utilized in growing the balance sheet, expanding the Bank's franchise value, and repurchasing shares versus paying a cash dividend. In addition, paying a nominal cash dividend would cause the Company to incur additional operating costs for processing, mailing, and tax information reporting. The Company has no current plans to commence paying cash dividends in 2002.

The Company did not conduct any share repurchases during 2001. However, as previously announced during the fourth quarter of 2001, the Company's Board of Directors has authorized a 114,035 share stock repurchase program commencing in December 2001.

The Company's tangible book value per share increased from $12.54 at December 31, 2000 to $14.08 at December 31, 2001. The Company's tangible book value per share benefits from the amortization of deferred stock compensation and core deposit intangibles, in addition to periodic earnings and other factors that add to stockholders' equity without increasing the number of shares outstanding.

Analysis Of Results Of Operations For The Years Ended December 31, 2000 And December 31, 1999

Overview

The Company reported net income of $2.5 million for the year ended December 31, 2000, down from net income of $3.3 million for the prior year. These amounts translate to $0.81 basic and diluted earnings per share in 2000, compared to $1.02 basic and $0.99 diluted earnings per share in 1999. The Company's return on average assets decreased from 0.73% in 1999 to 0.53% in 2000. The Company's average return on equity also fell, from 8.05% in 1999 to 6.24% in 2000. The overall reduction in net income during 2000 resulted from a number of factors, including a higher provision for loan losses, greater operating expenses, and less favorable results from the sale of securities. These factors more than offset increases in net interest income and most sources of non-interest income other than results from the sale of securities.

Net Interest Income

During the years ended December 31, 2000 and 1999, net interest income before the provision for loan losses was $18.0 million and $16.0 million, respectively. The level of average interest-earning assets over the same years was $454.1 million and $434.8 million, respectively. The net interest spread was 3.54% and 3.27%, respectively, for the years ended December 31, 2000 and 1999. During these same periods, the ratio of net interest income to average total assets was 3.79% and 3.53%, respectively.

The $2.0 million, or 12.2%, increase in net interest income generated in 2000 versus the prior year was primarily produced by three key changes in the Company's balance sheet composition:

1. On the asset side of the balance sheet, the Company redirected its earning asset mix towards loans receivable, reducing the proportion of

earning assets comprised of relatively lower yielding cash equivalents, investment securities, and mortgage backed securities. Loans receivable, net, increased from 78.0% of average interest earning assets in 1999 to 83.6% of average interest earning assets in 2000. Loans receivable, net, earned a weighted average rate of 8.57% during 2000, comparing favorably to 6.33% on cash equivalents, 7.73% on investment securities, and 6.98% on mortgage backed securities.

2. On the liability side of the balance sheet, the Company increased the percentage of average interest bearing liabilities composed of transaction deposit accounts (NOW, savings, and money market) from 31.2% in 1999 to 33.8% in 2000. Transaction deposit accounts present a relatively lower cost of funding than most alternative sources. The proportional increase in average transaction accounts was offset by a decline in the percentage of average interest bearing liabilities represented by certificates of deposit. Certificates of deposit represented 55.5% of average interest bearing liabilities in 2000, versus 58.4% the prior year.

3. The Company increased its average balance of interest earning assets by $19.3 million, or 4.4%, in 2000 versus 1999. Due to the deposit growth the Company achieved during 2000, this rise in average interest earning assets was accomplished with only a slight increase in the proportion of funding provided by comparatively higher cost borrowings. Borrowings as a percentage of average interest bearing liabilities increased from 10.4% in 1999 to 10.7% in 2000. The Company's larger average balance sheet in 2000 versus 1999 contributed to the $2.0 million rise in net interest income.

Average non-interest bearing liabilities increased from $19.4 million during 1999 to $19.8 million during 2000. Increases in average non-interest bearing liabilities, which primarily consist of demand deposit accounts, favorably impact the Company's net interest income.

Interest Income

Interest income for the year ended December 31, 2000 totaled $37.8 million, an increase of $4.3 million from the prior year. The increase resulted from a shift in asset mix toward higher yielding assets, the generally higher interest rate environment in 2000 versus 1999, a decision by the FHLB-SF to pay particularly high dividend rates during the first half of 2000 in conjunction with its capital management program, and a larger average balance of interest earning assets. The larger average balance of interest earning assets stemmed from the Company's desire to effectively utilize the Bank's regulatory capital and liquidity in building the size of the loan portfolio. The weighted average yield on interest earning assets increased from 7.69% during 1999 to 8.31% during 2000. The yield on the Company's assets generally benefits from a higher interest rate environment, as the vast majority of the Company's assets are either adjustable rate or fixed rate with limited duration.

Interest income on loans increased 18.9% from $27.2 million in 1999 to $32.6 million in 2000. This rise was due to a greater average balance of loans outstanding and higher average rates. The higher average rates stemmed from both the higher general interest rate environment and the shift in loan mix away from relatively lower yielding residential mortgages and toward generally higher yielding multifamily and commercial real estate loans.

Interest income on mortgage backed securities decreased from $4.9

million in 1999 to $3.8 million in 2000, as the impact of lower average balances more than offset the effect of higher average rates. A similar pattern applied to interest income on investment securities, which decreased from $871 thousand in 1999 to $689 thousand in 2000. The average rate on the Company's investments in corporate trust preferred securities rose relatively rapidly during 2000 due to their repricing quarterly based on the responsive three month LIBOR index. The increase in rate was, however, insufficient to offset the impact of lower average volumes resulting from the sale of corporate trust securities with a face value of $4.0 million during 2000.

Interest income on cash equivalents rose during 2000, as a greater average balance was complemented by higher average rates resulting from the increases in the target federal funds rate implemented by the Federal Reserve. The Company maintained a higher average balance of cash equivalents during 2000 primarily due to the periodic build up of excess liquidity in support of pending loan originations and purchases. In addition, during 2000, the Company placed $180 thousand in short term certificates of deposit with minority focused financial institutions in conjunction with its proactive program under the Community Reinvestment Act.

Interest Expense

Interest expense on deposits increased from $15.1 million during 1999 to $17.2 million during 2000 due to a combination of greater average balances and higher average rates. The greater average balances stemmed from the Company's deposit marketing initiatives throughout the year to attract more consumer and business deposit accounts. The average rate paid on deposits during 2000 increased from the prior year, despite a favorable shift in deposit mix, due to the higher general interest rate environment. The average cost of interest bearing deposits rose from 4.29% during 1999 to 4.66% during 2000.

Interest expense on borrowings increased from $2.3 million during 1999 to $2.5 million during 2000. Higher average volumes and greater average rates each contributed to the rise in interest expense. The Company primarily used FHLB advances as a source of borrowings during 2000, with MBBC far less active in selling securities under agreements to repurchase during 2000 versus prior years due to the sale of MBBC's security portfolio in early 2000.

Provision For Loan Losses

Provision for loan losses increased from $835 thousand during 1999 to $2.2 million during 2000. This increase resulted from the following factors:

1. The growth in the size of the loan portfolio during 2000.

2. Net charge-offs of $313 thousand in 2000 versus $113 thousand in 1999.

3. The continued shift in loan mix away from residential mortgages and toward income property loans, which typically present more credit risk than residential mortgages.

4. Specific reserves rose from $200 thousand at December 31, 1999 to $600 thousand at December 31, 2000. The $600 thousand specific reserve at December 31, 2000 was associated with a $2.85 million commercial construction loan located in the Company's primary market area. This loan was collected in full in April 2001.

5. The increasing credit concentrations in the Company's loan portfolio

associated with a smaller number of comparatively larger income property loans versus a larger number of comparatively smaller residential mortgages

6. An increase in unallocated general reserves from $266 thousand at December 31, 1999 to $739 thousand at December 31, 2000. This increase in unallocated reserves resulted from Management's concerns about several key factors which Management believes have negatively impacted the inherent loss in the Company's credit portfolio, including:

   - the California energy crisis, with impacts upon the availability and price of electricity, business costs, consumer spending and disposable income, and the pace of economic activity in the State

   - the financial difficulties experienced by many technology related companies in the Silicon Valley area adjacent to the Bank's primary market areas

   - the impact of lower technology stock prices on consumer spending, liquidity, and investment, with a particular concern regarding effects on the demand and pricing for real estate in the Bank's primary market areas

   - the general reduction in national economic growth and the increased volume of layoffs being announced by major corporations

Non-Interest Income

Non-interest income declined from $2.5 million in 1999 to $2.3 million in 2000. This decrease was primarily due to less favorable results on the sale of securities more than offsetting increased non-interest income from most other components of the Company's fee based businesses.

The Company experienced a net pre-tax loss of $55 thousand on the sale of mortgage backed and investment securities during 2000, versus a gain of $496 thousand in 1999. The gains realized in 1999 occurred during the first half of that year, in a comparatively low general interest rate environment that increased the market value of the Company's securities.

Customer service charges increased from $1.0 million during 1999 to $1.3 million during 2000 due to the growth in the customer base reflected in the increased number of transaction accounts combined with the implementation of a new fee & service charge schedule in mid 2000.

Commissions from the sale of non-insured products rose from $626 thousand in 1999 to $676 thousand in 2000. Income from loan servicing increased from $84 thousand in 1999 to $118 thousand in 2000.

Non-Interest Expense

Non-interest expense totaled $13.7 million in 2000, up $1.8 million from $11.9 million the prior year. Factors contributing to the rise in 2000 included:

1. Compensation and employee benefits increased from $5.6 million during 1999 to $6.6 million during 2000. This increase resulted from a number of factors, including:

   - The hiring of additional staff to support the Company's strategic plan, including the Bank's first experienced commercial loan officer.

- Changes in the Company's senior management team.

- The settlement of certain non-qualified benefits obligations.

- A $250 thousand accrual for a settlement package for the former President and Chief Operating Officer, arising from the employment agreements between the individual and the Company. This matter was finalized via binding arbitration in 2001.

- The implementation of an expanded performance based incentive compensation program.

2. Data processing expense increased from $1.0 million in 1999 to $1.14 million in 2000 due to servicing a greater volume of loan and deposit accounts and processing a greater number of transactions, and because of costs associated with the planned data processing conversion. The greater number of accounts and transaction also led to increased spending on supplies, printing, and postage costs.

3. The payment of $108 thousand in expenses during the fourth quarter of 2000 in support of the planned data processing conversion. These expenses included costs for travel, training, deconversion services from the existing data processor, and consultants assisting with the technology implementation.

4. Recruitment and relocation expenses for hiring new members of the Company's management team, including a new Chief Executive Officer, Chief Financial Officer, Controller, and Director of Commercial Lending.

5. The adoption of a Directors Emeritus program that provides cash recognition payments to retiring directors meeting certain eligibility requirements.

6. Higher outside professional costs. The Company incurred significant legal costs, in aggregate, during 2000 in conjunction with the successful collection of a $5.0 million non-performing loan, a review of charter alternatives, and addressing the potential settlement of claims by the former President & Chief Operating Officer. The Company also incurred higher accounting related costs in 2000 due to an expansion of its co-sourced internal audit program.

Primarily because of the higher operating costs described above, the Company's average efficiency ratio for 2000 increased to 67.3%, up from 64.1% during 1999. The transformation of the Company has also contributed to increases in the efficiency ratio, as up front operating costs and other expenses must often be incurred prior to the realization of associated revenues as the Company changes its business mix and redirects its sales efforts.

The Company's new management team commenced a series of initiatives to improve the Company's efficiency ratio during the second half of 2000. However, due to the time required to conclude existing contractual obligations, implement these initiatives (including employee training), and conduct required customer notification, many of these initiatives provided little economic benefit during 2000, but were expected to have a greater impact in 2001.

Provision For Income Taxes

The provision for income taxes decreased from $2.5 million during 1999 to $1.9 million during 2000 due to a reduction in pre-tax income. The Company's effective book tax rate increased slightly in 2000, in part due to the greater impact of non-deductible expenses and other tax related adjustments on a lower base of pre-tax income.

Comparison Of Financial Condition At December 31, 2000 And December 31, 1999

Total assets of the Company were $486.2 million at December 31, 2000, compared to $462.8 million at December 31, 1999, an increase of $23.4 million, or 5.0%.

Investment securities declined from $11.5 million at December 31, 1999 to $7.4 million at December 31, 2000 due to the sale of a corporate trust preferred security during 2000 in order to generate funding for the Company's increasing loan portfolio. The Company's investment security portfolio at December 31, 2000 was composed of two variable rate, quarterly repricing, corporate trust preferred securities issued by major US banks. These two securities were rated "A-" or better by Standard & Poors rating agency at December 31, 2000.

Mortgage backed securities declined from $57.8 million at December 31, 1999 to $43.0 million at December 31, 2000. This reduction stemmed from ongoing principal repayments (including prepayments), maturities, and the sale of mortgage backed securities with a face value of $24.5 million, partially offset by purchases during the year. The Company decreased the size of its mortgage backed security portfolio during 2000 to raise funds for investment into higher yielding loans receivable, improve the interest rate risk profile of the Company, and generate additional liquidity for MBBC.

The Company significantly altered the mix of its mortgage backed securities portfolio during 2000. Traditional Agency pass-through certificates declined from 54.1% of total mortgage backed securities at December 31, 1999 to 14.9% at December 31, 2000. In contrast, CMOs increased from 45.9% of total mortgage backed securities at December 31, 1999 to 85.1% at December 31, 2000. The Company undertook this change in mix:

- to reallocate the Company's capacity for longer term, fixed rate assets from the security portfolio to the loan portfolio, where management believes better yields are obtainable for the same level of interest rate risk

- to acquire CMOs that present relatively more certain cash flows (e.g. Planned Amortization Classes, or "PACs") than traditional pass-through certificates and thereby facilitate the Company's cash management

- to take advantage of the generally higher yields available in non-Agency CMOs versus those presented by similar profile Agency securities

All of the CMOs were rated "AAA" by at least one nationally recognized ratings agency at December 31, 2000.

Loans receivable held for investment, net, were $391.8 million at December 31, 2000, compared to $360.7 million at December 31, 1999. This 8.6% increase stemmed from $169.7 million in credit commitments during 2000, partially offset by repayments and sales. The mix in the portfolio of loans receivable held for investment, net, changed significantly during 2000, with a reduced concentration in residential mortgages and a significant increase in the proportion of income property loans (multifamily and commercial real estate). This change in loan mix was pursued in conjunction with the Company's strategic plan of transforming itself into a community commercial bank, and thereby financing a broader range of credit needs in the communities served. This change in mix also supports a greater yield on the loan portfolio and an increase in deposits, as the Company seeks to acquire operating accounts for income properties financed and for businesses receiving a line of credit or term business loan.

The Company's investment in the capital stock of the FHLB declined in 2000 due to a mandatory redemption required by the FHLB.

The Company's balance of premises and equipment, net, increased by $333 thousand in 2000 primarily due to leasehold improvements at one branch. This branch was remodeled to enable the leasing of the second floor to a tenant, thereby increasing the Company's future monthly rental income.

The Company continued to amortize its intangible assets during 2000, reducing their balance from $2.9 million at December 31, 1999 to $2.2 million at December 31, 2000. This amortization, which is a non-cash charge to operations, bolsters the Bank's regulatory capital ratios (all else held constant), as intangible assets are deducted from GAAP capital in determining regulatory capital. This amortization also increases the Company's tangible book value per share.

During 2000, the liabilities increased by $20.4 million to $442.4 million, from $422.0 million at December 31, 1999. An increase in deposits more than offset declines in other types of liabilities. Total deposits rose from $367.4 million at December 31, 1999 to $407.8 million at December 31, 2000. This increase resulted from multiple factors, including the introduction of new checking and money market products and the acquisition of $14.0 million in certificates of deposit through the State of California Time Deposit Program. The Bank was also successful in attracting some deposit customers during 2000 from local competitors undergoing a merger or acquisition.

FHLB advances declined from $49.6 million at December 31, 1999 to $32.6 million at December 31, 2000. Securities sold under agreements to repurchase declined from $2.4 million at December 31, 1999 to none at December 31, 2000. The inflow of deposits and the reduction in securities provided sufficient funds to fund the growth in loans receivable, retire maturing borrowings, and prepay certain borrowings during 2000. The Company did not pursue extensive leveraging via wholesale assets and liabilities during 2000, as Management determined that available risk adjusted spreads in the capital markets did not support the associated allocation of capital.

Stockholders' equity increased $3.0 million from $40.8 million at December 31, 1999 to $43.8 million at December 31, 2000, even with the repurchase of $1.25 million in Treasury shares during 2000 and the payment of $274 thousand in cash dividends during the first quarter of 2000. The rise in equity resulted from net income, continued amortization of deferred stock compensation, Company directors receiving their fees in Company stock, and an improvement in the fair value of securities classified as available for sale. The Company reduced its aggregate deferred stock compensation by $1.3 million during 2000. This significant reduction was caused by:

o ESOP shares continuing to be committed to be released under the terms of that tax qualified plan

o the distribution of certain non-qualified deferred compensation payable in Company stock

o the acceleration of benefits under the Recognition and Retention Plan for outside directors leading to the termination of that plan and the savings of future related administrative expense

o continued vesting of shares previously awarded under the Performance Equity Plan for officers and employees

o the use of Company stock for incentive payments in lieu of cash under certain employee incentive plans

Liquidity

Liquidity is actively managed to ensure sufficient funds are available to meet the ongoing needs of both the MBBC and the Bank. Liquidity management includes projections of future sources and uses of funds to ensure the availability of sufficient liquid reserves to provide for unanticipated circumstances. The Bank's primary sources of liquidity are deposits, principal and interest payments (including prepayments) on its asset portfolios, retained earnings, FHLB advances, other borrowings, and, to a lesser extent, sales of loans originated for sale and securities classified as available for sale. The Bank's primary uses of funds include loan originations, customer drawdowns on lines of credit and undisbursed construction loan commitments, loan purchases, customer withdrawals of deposits, interest paid on liabilities, and operating expenses.

Specific steps the Bank has taken to maintain strong liquidity include:

o Arranging four federal funds lines of credit with correspondent banks in an aggregate amount of $25.5 million. Funds under these lines are provided on an available, as opposed to on a committed, basis.

o Completing agreements to be able to issue "DTC" or publicly traded certificates of deposit through two large investment banks with significant national client bases. The Bank intends to enter into a third such agreement in 2002.

o Signing PSA agreements with a greater number of approved counterparties to facilitate the sale of securities under agreements to repurchase.

o Enrolling in the specific loan pledging program with the FHLB-SF and pledging multifamily and commercial real estate loans in addition to residential mortgages to the FHLB-SF to increase the Bank's borrowing capacity.

o Participating in the State of California Time Deposit Program.

o Reducing the duration of its security portfolio during 2001 to provide greater monthly cash flows.

The Bank pledges excess collateral to the FHLB in order to have ready access to additional liquidity. At December 31, 2001, the Bank maintained available borrowing capacity in excess of $125 million at the FHLB. In addition, at December 31, 2001, the Bank owned unpledged loans and securities that could be used for either liquidation or secured borrowings in order to meet future liquidity requirements.

From time to time, depending upon its asset and liability strategy, the Bank considers converting a portion of its residential whole loans into mortgage backed securities. These conversions provide increased liquidity because the mortgage backed securities are typically more readily marketable than the underlying loans and because they can more effectively be used as collateral for borrowings. The Bank did not securitize any portion of its residential mortgages during the years 1999 - 2001.

The Company's ratio of net loans to deposits was 107.92% at December 31, 2001. In 2002, the Company intends to actively manage this ratio by:

- introducing new deposit products and related services, including Internet banking for businesses
- modifying staff incentive programs to more strongly focus on expanding deposit relationships
- pursuing opportunities for additional branch locations
- directing a higher percentage of the advertising and promotion budget to deposit generation

At December 31, 2001, the Bank maintained $24.4 million in commitments to originate loans and lines of credit. Management anticipates that the Bank will have sufficient funds available to meet these commitments, not all of which will necessarily be drawn upon. For additional information regarding commitments and contingencies, including available customer balances under committed lines of credit, please refer to Note 15 to the Consolidated Financial Statements.

MBBC, as a company separate from the Bank, must provide for its own liquidity. Substantially all of MBBC's cash inflows are obtained from interest on its security and cash equivalent positions, repayment of the funds advanced for the ESOP, exercise of vested stock options, sales of treasury shares to the Bank for subsequent payment as director fees, and dividends declared and paid by the Bank. There are statutory and regulatory provisions that limit the ability of the Bank to pay dividends to MBBC. As of December 31, 2001, MBBC did not have any commitments for capital expenditures or to fund loans.

At December 31, 2001, MBBC maintained a revolving $3.0 million line of credit from a correspondent bank of the Bank. This line of credit is secured by 800,000 shares of MBBC's treasury stock. There were no outstanding balances on this line of credit at December 31, 2001. During 2001, MBBC renegotiated this line of credit to increase the facility from $2.0 million to $3.0 million and eliminate restrictions on the use of the line of credit to repurchase MBBC's common stock. The line of credit agreement contains various financial performance and reporting covenants. The terms of the line of credit do not impact or restrict MBBC's ability to pay cash dividends. The line of credit expires in December 2002. Management obtained this line of credit as a source of additional liquidity for MBBC, and, through MBBC, for the Bank. The Company expects to renew this line of credit or establish a similar line of credit with another bank at the end of 2002.

At December 31, 2001, MBBC had cash and cash equivalents of $4.6 million. This sum is sufficient to provide for approximately ten years of MBBC's current operating expenses in the absence of any cash inflows. Management knows of no factors that would restrict or eliminate the normally recurring cash inflows obtained by MBBC.

Capital Resources

The Bank's position as a "well capitalized" financial institution under the PCA regulatory framework is further enhanced by the financial resources present at the MBBC holding company level. At December 31, 2001, the consolidated GAAP capital position of the Bank was $45.6 million, while the consolidated GAAP capital position of the Company was $50.2 million. Note 14 to the Consolidated Financial Statements provides additional information concerning the Bank's regulatory capital position, including amounts by which the Bank exceeds minimum and "well capitalized" thresholds for regulatory capital.

Management believes the Bank's regulatory capital position in 2002 will continue to benefit from three key factors:

- the continued amortization of intangible assets
- the continued amortization of deferred stock compensation
- the Bank's earnings for the year

The potential continued increase in the size of the loan portfolio, combined with the ongoing planned shift in mix toward construction, income property, and business lending, may result in the Bank's having higher levels of nominal and risk weighted assets during 2002, thereby possibly offsetting the effect of the above factors upon regulatory capital ratios.

The Company has conducted share repurchases since 1995. Through December 31, 2001, the Company had repurchased 1,269,600 shares of its common stock. No share repurchases occurred in 2001, and 120,000 shares were repurchased in 2000. At December 31, 2001, there were 3,456,097 shares outstanding. In December 2001, the Company announced a repurchase authorization for an additional 114,035 shares, five thousand of which were acquired during the first quarter of 2002.

Transactions With Related And Certain Other Parties

The Company's conduct of business with Directors, Officers, significant stockholders, and other related parties (collectively, "Related Parties") is restricted and governed by various laws and regulations, including Regulation O as promulgated and enforced by the Federal Reserve. Furthermore, it is the Company's policy to conduct business with Related Parties only on an arms-length basis at current market prices with terms and conditions no more favorable than the Company provides in its normal course of business.

The Bank extends loans to its Directors and their related interests only after approval of a majority of disinterested Directors and with the associated Director abstaining from voting. The Bank also extends loans, primarily residential mortgages and home equity lines of credit, to its employees under its employee loan program. The Bank's Officers are eligible to participate in the employee loan program. Note 5 to the Consolidated Financial Statements presents the Company's credit commitments to Directors and executive officers.

The Company leases space in one of its owned administrative buildings to a partnership conducting a retail business. The spouse of one of the Company's Directors is a partner in the retail business. The associated month to month lease was negotiated on an arms length basis by disinterested Officers and approved by disinterested Directors. In early 2002, the Company received notification that the retail business was ceasing operations and terminating the lease in compliance with its terms.

The Company periodically utilizes the professional services of a marketing and advertising corporation with which one executive officer is affiliated. All business orders and all invoices associated with this corporation are approved by disinterested executive officers. Total payments to this marketing and advertising corporation in 2001 were $243 thousand, which included certain pass-through payments for media advertising.

The Company employs various individuals that are related to other employees, such as spouses, siblings, children, and other relatives. It is Company policy to disallow related employees to have a direct reporting or supervisory relationship. At December 31, 2001, the spouses of two executive officers were also employees of the Company.

The Company does not believe that the above transactions with related parties were conducted on other than an arms-length basis with normal terms and conditions. The Company also does not believe that the above transactions with related parties impaired stockholder value or presented any actual or potential conflicts of interest that were not appropriately addressed by disinterested parties.

Impact of Inflation And Changing Prices

The Consolidated Financial Statements and Notes thereto presented herein have been prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP"), which requires the measurement of most financial positions and operating results in terms of historical dollar amounts without considering the changes in the relative purchasing power of money over time due to inflation. Unlike industrial companies, the Company's assets and liabilities are nearly all monetary in nature. Consequently, relative and absolute levels of interest rates present a greater impact on the Company's performance and condition than do the effects of general levels of inflation. Interest rates do not necessarily move in the same direction or to the same extent as the prices of goods and services. The Company's operating costs, however, are subject to the impact of inflation, particularly in the case of salaries and benefits costs, which typically constitute almost one-half of the Company's total non-interest expense.

Recent Accounting Pronouncements

In June 2001, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standard ("SFAS") No. 141, "Business Combinations", and SFAS No.142, "Goodwill and Other Intangible Assets". SFAS No. 141 requires that all business combinations initiated after June 30, 2001 be accounted for under the purchase method of accounting and addresses the initial recognition and measurement of goodwill and other intangible assets acquired in a business combination. SFAS No. 142 addresses the initial recognition and measurement of intangible assets acquired outside of a business combination whether acquired individually or with a group of other assets. SFAS No. 142 also addresses the recognition and measurement of goodwill and other intangibles assets subsequent to their acquisition. SFAS No. 142 provides that intangible assets with finite useful lives will be amortized and that goodwill and intangible assets with indefinite lives will not be amortized, but will be required to be tested at least annually for impairment. The Company is required to adopt SFAS No. 142 beginning January 1, 2002. Early adoption is not permitted. The Company does not expect the adoption of SFAS No. 142 to have a material effect on its financial position, results of operations, or cash flows, as the Company had no goodwill as of December 31, 2001 and as all of the Company's intangible assets at December 31, 2001 were comprised of core deposit intangibles that will continue to amortize.

In August 2001, the Financial Accounting Standards Board ("FASB") approved for issuance Statement of Financial Accounting Standard (SFAS) No. 144, "Accounting For The Impairment Or Disposal Of Long-Lived Assets". SFAS No. 144 supersedes SFAS No. 121, "Accounting For The Impairment Of Long-Lived Assets And For Long-Lived Assets To Be Disposed Of" and the accounting and reporting provisions of Accounting Principles Board ("APB") Opinion No. 30, "Reporting The Results Of Operations - Reporting The Effects Of Disposal Of A Segment Of A Business, And Extraordinary, Unusual and Infrequently Occurring Events And Transactions". SFAS No. 144 unifies the accounting treatment for various types of long-lived assets to be disposed of, and resolves implementation issues related to SFAS No. 121. SFAS No. 144 is effective for financial statements issued for fiscal years beginning after December 15, 2001, and interim periods within those fiscal years. The Company will adopt SFAS No. 144 beginning January 1, 2002. The Company does not expect the adoption of SFAS No. 144 to have a material effect on its financial position, results of operations, or cash flows, as the Company had no long-lived assets that were impaired or that were to be disposed of as of December 31, 2001.

Item 7a. Quantitative And Qualitative Disclosure Of Market Risk.

The results of operations for financial institutions such as the Company may be materially and adversely affected by changes in prevailing economic conditions, including rapid changes in interest rates, declines in real estate market values, and the monetary and fiscal policies of the federal government. Interest rate risk ("IRR") and credit risk typically constitute the two greatest sources of financial exposure for banks and thrifts. For a discussion of the Company's credit risk, please see "Item 7. Management's Discussion And Analysis Of Financial Condition And Results Of Operations - Provision For Loan Losses". The Company utilizes no derivatives to mitigate either its credit risk or its IRR, instead relying on loan review and adequate loan loss reserves in the case of credit risk and portfolio management techniques in the case of IRR. The Company is not significantly exposed to foreign currency exchange rate risk, commodity price risk, or other market risks other than interest rate risk.

IRR represents the impact that changes in absolute and relative levels of general market interest rates might have upon the Company's net interest income, results of operations, and theoretical liquidation value, also called net portfolio value ("NPV"). Interest rate changes impact earnings and NPV in many ways, including effects upon the yields generated by variable rate assets, the cost of deposits and other sources of funds, the exercise of options embedded in various financial instruments (especially residential mortgages), and customer demand for and market supply of different financial assets, liabilities, and positions.

In order to manage IRR, the Company has established an Asset / Liability Management Committee ("ALCO"), which includes representatives from senior management and the Board of Directors. ALCO is responsible for managing the Company's financial assets and liabilities in a manner that balances profitability, IRR, and various other risks (e.g. liquidity). ALCO operates under policies and within risk limits prescribed by and periodically reviewed and approved by the Board of Directors.

The primary objective of the Company's IRR management program is to maximize net interest income while controlling IRR exposure to within prudent levels. Financial institutions are subject to IRR whenever assets and liabilities mature or reprice at different times (repricing, or gap, risk), based upon different capital markets indices (basis risk), for different terms (yield curve risk), or are subject to various embedded options, such as the right of mortgage borrowers to refinance their loans when general market interest rates decline. Companies with high concentrations of real estate lending, such as the Company, are significantly impacted by prepayment rates on loans, as such prepayments generally return investable funds to the Company at a time of relatively lower prevailing general market interest rates.

Decisions to control or accept IRR are analyzed with consideration of the probable occurrence of future interest rate changes. Stated another way, IRR management encompasses the evaluation of the likely additional return associated with an incremental change in the IRR profile of the Company. For example, having liabilities that mature or reprice faster than assets can be beneficial when interest rates decline, but may be detrimental when interest rates rise. Assessment of potential changes in market interest rates and the relative financial impact to earnings and NPV is used by the Company to help quantify and manage IRR. As with credit risk, the complete elimination of IRR would curtail the Company's profitability, as the Company generates a return, in part, through effective risk management.

The Company monitors its interest rate risk using various analytical methods that include participation in the OTS net portfolio value interest rate risk modeling. The Company's exposure to IRR as of December 31, 2001 was within the limits established by the Board of Directors.

A common, if analytically limited, measure of financial institution IRR is the institution's "static gap". Static gap is the difference between the amount of assets and liabilities (adjusted by off balance sheet positions, if any) that are expected to mature or reprice within a specified period. A static gap is considered positive when the amount of interest rate sensitive assets exceeds the amount of interest rate sensitive liabilities in a given time period or cumulatively through that time period. The converse is true for a negative static gap.

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The following table presents the maturity and rate sensitivity of interest-earning assets and interest-bearing liabilities as of December 31, 2001. The "repricing gap" figures in the table reflect the estimated difference between the amount of interest-earning assets and interest-bearing liabilities that are contractually scheduled to mature or reprice (whichever occurs first) during future periods.

	At December 31, 2001				
	3 Months Or Less	More Than 3 Months To 1 Year	More Than 1 Year To 3 Years	More Than 3 Years To 5 Years	
				(Dollars In Tho	
Assets					
Interest earning cash equivalents	$ 898	$ --	$ --	$ --	$
Investment securities	7,300	--	--	--	
Mortgage backed securities	4,691	--	--	907	
Loans held for sale	--	--	--	--	
Loans receivable, net of LIP	124,687	104,420	101,237	121,020	
FHLB stock	2,998	--	--	--	

Gross interest-earning assets	140,574	104,420	101,237	121,927	
Plus / (Less):					
Unamortized yield adjustments	--	--	--	--	
Allowance for loan losses	--	--	--	--	
Interest-earning assets	140,574	104,420	101,237	121,927	
Non-interest-earning assets	--	--	--	--	
Total assets	$140,574	$104,420	$101,237	$121,927	$
Liabilities and Equity					
NOW accounts	$ 42,557	$ --	$ --	$ --	
Savings accounts	19,127	--	--	--	
Money market accounts	105,828	--	--	--	
Certificates of deposit	81,022	112,041	46,160	4,542	
Total interest-bearing deposits	248,534	112,041	46,160	4,542	
Borrowings	218	13,000	33,282	6,300	
Total interest bearing liabilities	248,752	125,041	79,442	10,842	
Non-interest bearing liabilities	--	--	--	--	
Stockholders' equity	--	--	--	--	
Total liabilities and equity	$248,752	$125,041	$ 79,442	$ 10,842	$
Periodic repricing gap	(108,178)	(20,621)	21,795	111,085	
Cumulative repricing gap	(108,178)	(128,799)	(107,004)	4,081	
Periodic repricing gap as a % of interest earning assets	(21.3%)	(4.2%)	4.3%	21.8%	
Cumulative repricing gap as a % of interest earning assets	(21.3%)	(25.3%)	(21.0%)	0.8%	
Cumulative net interest-earning assets as a % of cumulative interest-bearing liabilities	56.5%	65.5%	76.4%	100.9%	

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As presented in the prior table, at December 31, 2001, the Company's cumulative one year and three year static gaps, based upon contractual repricing and maturities (i.e. ignoring prepayments and other non-contractual factors) were (25.3%) and (21.0%), respectively, of total interest earning assets. These figures suggest that net interest income would increase if general market interest rates were to decline (and vice-versa), reflecting a "net liability sensitive" position.

However, static gap analysis such as that presented above fails to capture material components of IRR, and therefore provides only a limited, point in time view of the Company's IRR exposure. The assumptions and factors that are by definition excluded from static gap analysis prepared on a contractual basis encompass:

- prepayments on assets
- how rate movements and the shape of the Treasury curve, or the LIBOR swap curve, affect borrower behavior
- that all loans and deposits repricing at a given time will not adjust to the same degree or by the same magnitude
- that the nature of rate changes for assets and liabilities in the over one-year category have a greater long term economic impact than those for shorter term assets and liabilities
- transaction deposit accounts (significant to the Company) do not have scheduled repricing dates or contractual maturities, and therefore may respond to interest rate changes differently than other financial instruments
- potential Company strategic and operating responses to changes in absolute and relative interest rate levels
- the financial impact of options embedded in various financial instruments

Another measure of IRR, required to be performed by insured depository institutions regulated by the OTS, is a procedure specified by Thrift Bulletin 13a, "Interest Rate Risk Management". This test measures the impact upon NPV of an immediate and sustained change in interest rates in 100 basis point increments. The following table presents the estimated impacts of such changes in interest rates upon the Company as of December 31, 2001, calculated in compliance with Thrift Bulletin 13a. However, the results from any cash flow simulation model are dependent upon a lengthy series of assumptions about current and future economic, behavioral, and financial conditions, including many factors over which the Company has no control. These assumptions include, but are not limited to, prepayment rates on various asset portfolios and decay rates on core deposits, including savings, checking, and money market accounts. Because of the uncertainty regarding the accuracy of assumptions utilized and because such an analytical technique does not contemplate any actions the Company might undertake in response to changes in interest rates, no assurance can be provided that the valuations presented in the following table are representative of what might actually be obtainable. In addition, the following figures are by definition not indicative of the Company's economic value as a going concern or of the Company's market value.

		Projected Change From Base Scenario In	
(Dollars In Thousands)	NPV	Dollars	Percent
Change In Interest Rates (In Basis Points)			
+300	$ 62,594	$(11,593)	(15.6%)
+200	67,775	(6,412)	(8.6%)
+100	71,415	(2,772)	(3.7%)
Base Scenario	74,187	--	--
-100	75,861	1,674	2.3%

Note: NPV results for downward rate changes of more than 100 basis points were not calculated at 12/31/01 due to the low level of interest rates.

The level of interest rate risk exposure presented in the above table is generally considered "low" in the financial services industry.

The prior table results show that the Company's liquidation value benefits from declining interest rates, and is reduced by rising interest rates. Such results are directionally consistent with the static gap analysis presented above. The reduction in net portfolio value associated with rising interest rate scenarios in part results from the embedded options, held by borrowers, within most mortgage related products, as described in the following two paragraphs.

Under rising interest rates, the Company's assets experience a lengthening of duration and slower repricing relative to the liability side, resulting in a reduction of NPV. This occurs due to the slower prepayment behavior (under rising rates) the analysis assumed on mortgage related assets, and in conjunction with embedded options such as periodic and lifetime rate adjustment caps on adjustable rate loans. This prepayment behavior is a result of borrowers behaving in their economic self interests by more slowly (or not at all) curtailing or prepaying loans with interest rates at or below current market rates.

Under falling interest rates, the increase in the Company's net portfolio value is constrained by a shortening of asset duration. This occurs due to the faster prepayment behavior (under falling rates) the analysis assumed on mortgage related assets, as borrowers take advantage of a lower interest rate environment to refinance their loans. This assumed refinancing provides cash flow into the Company at a time when reinvestment alternatives present lower rates than the assets being paid off. Therefore, due to borrower use of embedded options in mortgage loans, the Company's net portfolio value increases less in a declining rate scenario than it falls in a similar rising rate scenario. This financial pattern is typical of community banks that have residential mortgages as a significant component of their loan portfolios.

A considerable portion of the total IRR exposure at December 31, 2001 was concentrated in two portfolios:

1. hybrid (i.e. fixed for 3 - 5 years, then variable) residential mortgages
2. long term, fixed rate residential mortgages held for investment

The Company added significant volumes of hybrid residential mortgages to its balance sheet early in 2001, including loan pool purchases, in order to take advantage of the rapidly declining interest rate environment and better leverage the Bank's capital position. In addition, customer demand for hybrid mortgages was strong in 2001, fueled in the latter half of the year by the steeper Treasury yield curve that rendered these products comparatively attractively priced versus longer term, fixed rate mortgages. During 2001, the Company continued selling the vast majority of its long term, fixed rate residential mortgage originations, leading to a decline in that portfolio segment throughout the year as older loans amortized and prepaid.

As general market interest rates appeared to be approaching a cyclical bottom in the latter part of 2001, the Company implemented various steps to reduce its net liability sensitivity. These actions included:

- decreasing the duration of the securities portfolio
- pricing loan products to more strongly encourage customer selection of more interest rate sensitive loans
- extending the term structure of borrowings

o actively marketing longer term certificates of deposit

In addition, the Company's strategic plan encompasses a reduced net liability sensitivity through the growth of transaction deposit account balances, particularly comparatively interest rate insensitive checking accounts, and the expansion of commercial banking. Commercial banking is by nature an asset sensitive business, as loans are generally variable rate, frequently based upon the Prime Rate, while deposits often include a significant non-interest bearing demand deposit component. In addition, the planned shift in loan mix away from the historical concentration in residential mortgages toward generally more interest rate sensitive, and higher yielding, income property and construction loans is also planned to reduce the Company's net liability sensitivity.

Despite the Company's IRR management program and the initiatives detailed above, due to the multiple factors which influence the Company's exposure to IRR, many of which are beyond the control of the Company, there can be no assurance that the Company's earnings or economic value will be maintained in future periods, nor that the Company will be successful in continuing to maintain a relatively low level of IRR exposure.

Item 8. Financial Statements And Supplementary Data.

Index To Consolidated Financial Statements

INDEPENDENT AUDITORS' REPORT

The Board of Directors
Monterey Bay Bancorp, Inc.
Watsonville, California

We have audited the accompanying consolidated statements of financial condition of Monterey Bay Bancorp, Inc. and subsidiary as of December 31, 2001 and 2000, and the related consolidated statements of income, changes in stockholders' equity and cash flows for each of the three years in the period ended December 31, 2001. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of Monterey Bay Bancorp, Inc. and subsidiary as of December 31, 2001 and 2000, and the results of their operations and their cash flows, for each of the three years in the period ended December 31, 2001 in conformity with accounting principles generally accepted in the United States of America.

/s/ Deloitte & Touche LLP

San Francisco, California
January 29, 2002

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MONTEREY BAY BANCORP, INC. AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION
DECEMBER 31, 2001 AND 2000

(Dollars In Thousands, Except Per Share Amounts)

ASSETS	
Cash and cash equivalents	$ 13
Securities available for sale, at estimated fair value:	
Investment securities	7
Mortgage backed securities	30
Loans held for sale, at lower of cost or market	
Loans receivable held for investment (net of allowances for loan losses of $6,665 at December 31, 2001 and $5,364 at December 31, 2000)	465
Investment in capital stock of the Federal Home Loan Bank, at cost	2
Accrued interest receivable	2
Premises and equipment, net	7
Core deposit intangibles, net	1
Other assets	4
TOTAL ASSETS	$537

LIABILITIES AND STOCKHOLDERS' EQUITY

LIABILITIES	
Deposits	$432
Advances from the Federal Home Loan Bank and other borrowings	53
Accounts payable and other liabilities	1
Total liabilities	487
Commitments and contingencies	
STOCKHOLDERS' EQUITY	
Preferred stock, $0.01 par value, 2,000,000 authorized; none issued Common stock, $0.01 par value, 9,000,000 shares authorized; 4,492,085 issued at December 31, 2001 and December 31, 2000; 3,456,097 outstanding at December 31, 2001 and 3,321,210 outstanding at December 31, 2000	
Additional paid-in capital	28
Retained earnings, substantially restricted	36
Unallocated ESOP shares	
Treasury shares designated for compensation plans, at cost (17,969 shares at December 31, 2001 and 35,079 shares at December 31, 2000)	
Treasury stock, at cost (1,035,988 shares at December 31, 2001 and 1,170,875 shares at December 31, 2000)	(14
Accumulated other comprehensive loss, net of taxes	
Total stockholders' equity	50
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$537

See Notes to Consolidated Financial Statements

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MONTEREY BAY BANCORP, INC. AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF INCOME
YEARS ENDED DECEMBER 31, 2001, 2000, AND 1999
(Dollars In Thousands, Except Per Share Amounts)

	Year Ended D	
INTEREST AND DIVIDEND INCOME:	2001	
Loans receivable	$ 35,485	$ 32
Mortgage backed securities	2,360	3
Investment securities and cash equivalents	886	1
Total interest and dividend income	38,731	37

INTEREST EXPENSE:		
Deposit accounts	16,449	17
Advances from the Federal Home Loan Bank and other borrowings	2,541	2
Total interest expense	18,990	19
NET INTEREST INCOME BEFORE PROVISION FOR LOAN LOSSES	19,741	17
PROVISION FOR LOAN LOSSES	1,400	2
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	18,341	15
NON-INTEREST INCOME:		
Gains (losses) on sale of mortgage backed securities and investment securities, net	190	
Commissions from sales of noninsured products	244	
Customer service charges	1,688	1
Income from loan servicing	101	
Gain on sale of loans	88	
Other income	255	
Total	2,566	2
NON-INTEREST EXPENSE:		
Compensation and employee benefits	6,857	6
Occupancy and equipment	1,652	1
Deposit insurance premiums	198	
Data processing fees	876	1
Legal and accounting expenses	863	
Supplies, postage, telephone, and office expenses	663	
Advertising and promotion	249	
Amortization of intangible assets	681	
Consulting	333	
Other expenses	1,997	1
Total	14,369	13
INCOME BEFORE PROVISION FOR INCOME TAXES	6,538	4
PROVISION FOR INCOME TAXES	2,787	1
NET INCOME	$ 3,751	$ 2
EARNINGS PER SHARE:		
BASIC EARNINGS PER SHARE	$ 1.15	$
DILUTED EARNINGS PER SHARE	$ 1.12	$

See Notes to Consolidated Financial Statements

MONTEREY BAY BANCORP, INC. AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
YEARS ENDED DECEMBER 31, 2001, 2000, AND 1999

(Dollars And Shares In Thousands)

	Common Stock Shares	Common Stock Amount	Additional Paid-In Capital	Retained Earnings	Unallocated ESOP Shares	Treasur Share Desig nate Fo Com pen satio Plan
Balance At January 1, 1999	3,505	$45	$ 27,826	$ 27,702	$(1,380)	$ (95
Purchase of treasury stock	(116)					
Options exercised using treasury stock	34		60			
Dividends paid ($0.15 per share)				(530)		
Amortization of stock compensation			351		230	25
Purchase of stock for stock compensation plans						(68
Comprehensive income:						
Net income				3,301		
Other comprehensive income:						
Change in net unrealized gain / (loss) on securities available for sale, net of taxes of $(1,168)						
Reclassification adjustment for gains on securities available for sale included in income, net of taxes of $(204)						
Other comprehensive income, net						
Total comprehensive income						
Balance at December 31, 1999	3,423	$45	$ 28,237	$ 30,473	$(1,150)	$(1,37

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See Notes to Consolidated Financial Statements

MONTEREY BAY BANCORP, INC. AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY (Continued)
YEARS ENDED DECEMBER 31, 2001, 2000, AND 1999

(Dollars And Shares In Thousands)

	Common Stock						
	Shares	Amount	Additional Paid-In Capital	Retained Earnings	Unallocated ESOP Shares	Treasury Shares Designated For Compensation Plans	Trea S
Balance At December 31, 1999	3,423	$45	$ 28,237	$ 30,473	$(1,150)	$(1,376)	$(14
Purchase of treasury stock	(120)						(1
Cash dividends paid ($0.08 per share)				(274)			
Director fees paid using treasury stock	18		9				
Amortization of stock compensation			32		230	822	
Sale of stock for stock compensation plans						216	
Comprehensive income:							
Net income				2,523			
Other comprehensive income: Change in net unrealized gain / (loss) on securities available for sale, net of taxes of $359							
Reclassification adjustment for losses on securities available for sale included in income, net of taxes of $23							
Other comprehensive income, net							
Total comprehensive income							

	Shares	Amount	Additional Paid-In Capital	Retained Earnings	Unallocated ESOP Shares	Treasury Shares Designated For Compensation Plans	$(15
Balance at December 31, 2000	3,321	$45	$ 28,278	$ 32,722	$ (920)	$ (338)	$(15

See Notes to Consolidated Financial Statements

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MONTEREY BAY BANCORP, INC. AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY (Continued)
YEARS ENDED DECEMBER 31, 2001, 2000, AND 1999

(Dollars And Shares In Thousands)

	Common Stock Shares	Common Stock Amount	Additional Paid-In Capital	Retained Earnings	Unallocated ESOP Shares	Treasury Shares Designated For Compensation Plans	Trea S
Balance At December 31, 2000	3,321	$45	$ 28,278	$ 32,722	$ (920)	$ (338)	$(15
Options exercised using treasury stock	116		(5)				1
Director fees paid using treasury stock	19		47				
Amortization of stock compensation			264		230	165	
Comprehensive income:							
Net income				3,751			
Other comprehensive income:							
Change in net unrealized gain / (loss) on securities available for sale, net of taxes of $465							
Reclassification adjustment for gains on securities available for sale included in income, net of taxes of $(78)							
Other comprehensive income, net							
Total comprehensive income							

Balance at December 31, 2001	3,456	$45	$ 28,584	$ 36,473	$ (690)	$ (173)	$(14

See Notes to Consolidated Financial Statements

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MONTEREY BAY BANCORP, INC. AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF CASH FLOWS
YEARS ENDED DECEMBER 31, 2001, 2000, AND 1999

(Dollars In Thousands)

	Year Ended	
	2001	
OPERATING ACTIVITIES:		
Net income	$ 3,751	$ 2
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization of premises and equipment	663	
Amortization of intangible assets	681	
Amortization of purchase premiums, net of accretion of discounts	241	
Amortization of deferred loans fees and costs, net	(223)	
Provision for loan losses	1,400	2
Provision for real estate losses	--	
Federal Home Loan Bank stock dividends	(184)	
Gross ESOP expense before dividends received on unallocated shares	437	
Compensation expense related to stock compensation plans	200	
Director retainer fees paid in stock	219	
(Gain) loss on sale of investment and mortgage-backed securities	(190)	
Gain on the sale of loans held for sale	(88)	
Loss (gain) on sale of real estate acquired via foreclosure	--	
(Gain) loss on sale of fixed assets	(8)	
Origination of loans held for sale	(12,112)	(2
Proceeds from sales of loans held for sale	11,487	2
Deferred income taxes	(521)	
Increase in accrued interest receivable	(14)	
(Increase) decrease in other assets	(1,177)	
(Decrease) increase in accounts payable and other liabilities	(893)	
Other, net	(830)	(1
Net cash provided by operating activities	2,839	4
INVESTING ACTIVITIES:		
Net increase in loans held for investment	(74,067)	(31
Purchases of investment securities available for sale	--	
Proceeds from sales of investment securities available for sale	--	3

Purchases of mortgage backed securities available for sale	(29,250)	(26
Principal repayments on mortgage backed securities available for sale	30,337	18
Proceeds from maturities of mortgage backed securities held to maturity	--	
Proceeds from sales of mortgage backed securities available for sale	12,287	24
Redemptions (purchases) of FHLB stock, net	70	
Purchases of premises and equipment	(1,129)	
Proceeds from the sale of premises and equipment	11	
Net cash used in investing activities	(61,741)	(11

See Notes to Consolidated Financial Statements

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MONTEREY BAY BANCORP, INC. AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)
YEARS ENDED DECEMBER 31, 2001, 2000, AND 1999

(Dollars In Thousands)

	Year End	
	2001	
FINANCING ACTIVITIES:		
Net increase (decrease) in deposits	24,551	40
Proceeds (repayments) of FHLB advances, net	21,000	(17
Proceeds (repayments) of other borrowings, net	218	(2
Cash dividends paid to stockholders	--	
Purchases of treasury stock	--	(1
Sales of treasury stock for exercise of stock options	1,053	
Sales (purchases) of stock for stock compensation plans, net	--	
Net cash provided by financing activities	46,822	19
NET (DECREASE) INCREASE IN CASH & CASH EQUIVALENTS	(12,080)	12
CASH & CASH EQUIVALENTS AT BEGINNING OF YEAR	25,159	12
CASH & CASH EQUIVALENTS AT END OF YEAR	$ 13,079	$ 25
SUPPLEMENTAL CASH FLOW DISCLOSURES:		
Cash paid during the period for:		
Interest on deposits and borrowings	19,147	19
Income taxes	4,150	3

SUPPLEMENTAL DISCLOSURES OF NON CASH

INVESTING AND FINANCING ACTIVITIES:

Loans transferred to held for investment, at market value	85
Real estate acquired in settlement of loans	--

See Notes to Consolidated Financial Statements

MONTEREY BAY BANCORP, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
YEARS ENDED DECEMBER 31, 2001, 2000, AND 1999

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1. BASIS OF PRESENTATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Organization And Nature Of Operations

Monterey Bay Bancorp, Inc. ("MBBC") is a unitary savings and loan holding company incorporated in 1994 under the laws of the state of Delaware. MBBC operates as the holding company for its wholly owned subsidiary Monterey Bay Bank (the "Bank"), a federally chartered savings and loan association. The Bank has one wholly owned subsidiary, Portola Investment Corporation ("Portola"), which sells various non-FDIC insured investment products and provides trustee services to the Bank. Portola operates within the Bank's facilities in segregated areas. MBBC, the Bank, and Portola are hereinafter collectively referred to as the "Company".

The Company's primary business is attracting checking, money market, savings, and certificate of deposit accounts through its branch facilities and various electronic means, and investing such deposits and other available funds in various types of loans, including real estate mortgages, business loans, construction loans, and consumer loans. The Company also provides a range of fee based services. The Bank's deposit gathering and lending markets are primarily concentrated in the communities surrounding its full service offices located in Santa Cruz, Northern Monterey, and Southern Santa Clara Counties, in California. At December 31, 2001, the Bank maintained eight full service branch offices, two administrative buildings, and eleven ATM's, two of which were stand-alone.

Summary Of Significant Accounting Policies

Basis of Consolidation - The consolidated financial statements include the accounts of Monterey Bay Bancorp, Inc. and its wholly-owned subsidiary, Monterey Bay Bank, and the Bank's wholly-owned subsidiary, Portola Investment Corporation. All significant inter-company transactions and balances are eliminated in consolidation.

Financial Statement Presentation And Use Of Estimates - The financial statements have been prepared and presented in accordance with accounting principles generally accepted in the United States of America, or "GAAP" and general practices within the banking and savings and loan industry. The preparation of the financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, and contingent assets and liabilities, and disclosure of contingent assets and liabilities, as of the balance sheet dates and revenues and expenses for the reporting periods. Actual results could differ from those estimates.

Cash And Cash Equivalents - Cash and cash equivalents include cash on hand, amounts due from banks, federal funds sold, investments in money market mutual funds, securities purchased under agreements to resell with original maturities of three months of less, certificates of deposit with original maturities of three months or less, and highly liquid debt instruments purchased with remaining terms to maturity of three months or less from the date of acquisition.

Securities Available For Sale - Securities to be held for indefinite periods of time, including securities that management intends to use as part of its asset / liability management strategy that may be sold in response to changes in interest rates, loan prepayments, or other factors, are classified as available for sale. Securities available for sale are carried at estimated fair value. Gains or losses on the sale of securities are determined using the specific identification method. Premiums and discounts are recognized in interest income using the interest method over the period to contractual maturity. Unrealized holding gains or losses, net of tax, for securities available for sale are reported within accumulated other comprehensive income, which is a separate component of stockholders' equity, until realized.

A decline in the fair value of individual securities available for sale below their cost that is deemed other than temporary would be recognized through a write down of the investment securities to their fair value by a charge to earnings as a realized loss.

All of the Company's securities were classified as available for sale at December 31, 2001 and 2000.

Mortgage Backed Securities - The Company's mortgage backed securities include collateralized mortgage obligations ("CMO's") issued by both federal Agencies and private entities ("private label CMO's"). Private label CMO's expose the Company to credit and liquidity risks not typically present in federal Agency issued securities.

Loans Held For Sale - Loans held for sale are carried at the lower of aggregate cost, including qualified loan origination costs and related fees, or estimated market value, grouped by category. Unrealized losses by category are recognized via a charge against operations. Realized gains and losses on loans held for sale are accounted for under the specific identification method. Qualified loan origination fees and costs are retained and not amortized during the period the loans are held for sale. Transfers of loans held for sale to the held for investment portfolio are recorded at the lower of cost or estimated market value on the transfer date. The Company had $713 thousand in loans held for sale at December 31, 2001 and none at December 31, 2000. However, the Company did originate and hold loans for sale during each of the three years ended December 31, 2001, 2000, and 1999.

Loans Receivable Held For Investment - Loans receivable held for investment are stated at unpaid principal balances less undisbursed loan funds for constructions loans, unearned discounts, deferred loan origination fees, and allowances for estimated loan losses, plus unamortized premiums (including purchase premiums) and qualified deferred loan origination costs. These loans are not adjusted to the lower of cost or market because it is management's intention, and the Company has the ability, to hold these loans to maturity.

Interest Income On Loans - Interest income on loans is accrued and credited to income as it is earned. However, interest is generally not accrued on loans over 90 days contractually delinquent. In addition, interest is not accrued on loans that are less than 90 days contractually delinquent, but where management has identified concern over future collection. Accrued interest income is reversed when a loan is placed on non-accrual status. Discounts, premiums, and net deferred loan origination fees and costs are amortized into interest income over the contractual lives of the related loans using a procedure approximating the interest method, except when a loan is in non-accrual status. When a loan pays off or is sold, any unamortized balance of any related premiums, discounts, and qualified net deferred loan origination fees and costs is recognized in income. Payments received on non-accrual loans are allocated between principal and interest based upon the terms of the underlying note.

Sales Of Loans - Gains or losses resulting from sales of loans are recorded at the time of sale and are determined by the difference between (i) the net sales proceeds plus the estimated fair value of any interests retained in the loans, such as loan servicing rights, and (ii) the carrying value of the assets sold. The difference between the adjusted carrying value of the interests retained and the face amount of the interests retained is amortized to operations over the estimated remaining life of the associated loans using a method that approximates the interest method. The fair value of any interests retained is periodically evaluated, with any shortfall in estimated fair value versus carrying amount being charged against operations.

Troubled Debt Restructured - A loan is considered "troubled debt restructured" when the Company provides the borrower certain concessions that it would not normally consider. The concessions are provided with the objective of maximizing the recovery of the Company's investment. Troubled debt restructured includes situations in which the Company accepts a note (secured or unsecured) from a third party in payment of its receivable from the borrower, other assets in payment of the loan, an equity interest in the borrower or its assets in lieu of the Company's receivable, or a modification of the terms of the debt including, but not limited to, (i) a reduction in the stated interest rate to below market rates, (ii) an extension of maturity at an interest rate or other terms below market, (iii) a reduction in the face amount of the debt, and / or (iv) a reduction in the accrued interest receivable.

Impaired Loans - The Company considers a loan to be impaired when it is deemed probable by management that the Company will be unable to collect all contractual interest and contractual principal payments in accordance with the terms of the original loan agreement. However, when determining whether a loan is impaired, management also considers the current ratio of the loan's balance to collateral value, other sources of repayment, and the borrower's present financial position. In evaluating whether a loan is considered impaired, insignificant delays or shortfalls in payments, in the absence of other facts and circumstances, would not alone lead to the conclusion that a loan is impaired. The Company includes among impaired loans all loans that (i) are contractually delinquent 90 days or more, (ii) meet the definition of a troubled debt restructuring, (iii) are classified in part or in whole as either doubtful or loss, (iv) the Company has suspended accrual of interest, and (v) have a specific loss allowance applied to adjust the loan to fair value. The Company may also classify other loans as impaired based upon their specific circumstances.

The Company accounts for impaired loans, except those loans that are accounted for at market value or at the lower of cost or market value, at the present value of the expected future cash flows discounted at the loan's effective interest rate at the date of initial impairment, or, as a practical expedient, at the loan's observable market price or fair value of the collateral if the loan is collateral dependent. The Company evaluates the collectibility of both contractual interest and contractual principal when assessing the need for a loss accrual for impaired loans. Interest income received on impaired non-accrual loans is recognized on a cash basis. Interest income on other impaired loans is recognized on an accrual basis. The Company uses the cash basis method of accounting for payments received on impaired loans.

Allowances For Loan Losses - The Company maintains an allowance for loan losses to absorb probable losses inherent in the loan portfolio. The allowance is based on ongoing assessments of the probable estimated inherent losses. Loans are charged against the allowance when management believes the principal to not be recoverable. The allowance is increased by the provision for loan losses. The provision for loan losses is charged against current period operating results. The allowance is decreased by the amount of charge-offs, net of recoveries. The Company's methodology for assessing the appropriateness of the allowance consists of several key elements, which include the formula allowance, specific allowances, and the unallocated allowance.

The formula allowance is calculated by applying loss factors to outstanding loans and certain unused commitments. Loss factors reflect management's estimate of the inherent loss in various segments of the loan portfolio. Loss factors are determined based upon various information, including the Company's historical loss experience. Loss factors may be adjusted for factors that, in management's judgment, affect the collectibility of the portfolio as of the evaluation date.

Specific allowances are established for loans that are deemed impaired if the fair value of the loan or the collateral or the present value of expected future cash flows is estimated to be less than the Company's investment in the loan. In developing specific valuation allowances, the Company considers (i) the estimated cash payments expected to be received by the Company, (ii) the estimated net sales proceeds from the loan or its collateral, (iii) cost of refurbishment, (iv) certain operating income and expenses, and (v) the costs of acquiring and holding the collateral. The Company charges off a portion of an impaired loan against the specific allowance when that portion is deemed probable to not be recoverable.

The unallocated allowance is based upon management's evaluation of various conditions that are not directly measured in the determination of the formula and specific allowances. The evaluation of the inherent loss with respect to these conditions is subject to a higher degree of uncertainty because they are not identified with specific problem credits or portfolio segments. The conditions evaluated in connection with the unallocated allowance may include existing general economic and business conditions affecting key lending areas of the Company, the status of the real estate market in California, credit quality trends, delinquencies, collateral values, loan volumes, concentrations, and seasoning, specific industry conditions, recent loss experience, and the duration of the business cycle.

MONTEREY BAY BANCORP, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
YEARS ENDED DECEMBER 31, 2001, 2000, AND 1999 (Continued)

While management uses currently available information to determine the allowance for loan losses, additions to or recoveries from the allowance may be necessary based upon a number of factors including, but not limited to, changes in economic conditions and credit quality trends, particularly in the real estate market, borrower financial status, the regulatory environment, real estate values, and loan portfolio size and composition. Many of these factors are beyond the Company's control and, accordingly, periodic provisions for loan losses may vary from time to time. In addition, various regulatory agencies, as an integral part of the examination process, periodically review the Bank's allowance for loan losses. Such regulatory agencies may develop judgements different from those of management and may require the Bank to recognize additional provisions against operations.

Premises And Equipment - Land is carried at cost. Other premises and equipment are stated at cost, less accumulated depreciation and amortization. The Company depreciates or amortizes premises and equipment on a straight-line basis over the estimated useful lives of the various assets, and amortizes leasehold improvements over the shorter of the asset's useful life or the remaining term of the lease. The useful lives for the principal classes of assets are:

Asset	Useful Life
Buildings	30 to 40 years
Leasehold improvements	Shorter of remaining term of lease or life of improvement
Furniture and equipment	3 to 10 years

The cost of repairs and maintenance is charged to operations as incurred, whereas expenditures that improve or extend the service lives of assets are capitalized.

Impairment Of Long-Lived Assets Other Than Core Deposit Intangibles - The Company's primary long-lived assets other than core deposit intangibles are its branches and administrative buildings. The Company periodically evaluates the recoverability of these long-lived assets. Long-lived assets to be held and used are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of assets may not be recoverable. Determination of recoverability is based on an estimate of undiscounted future cash flows resulting from the use of the asset and its eventual disposition. Measurement of an impairment loss for long-lived assets that management expects to hold and use are based on the fair value of the asset. Long-lived assets to be disposed of are reported at the lower of carrying amount or fair value less estimated cost to sell.

Core Deposit Intangibles - These assets arise from the acquisition of deposits and are amortized on a straight-line basis over the estimated life of the deposit base acquired, generally seven years. The Company periodically evaluates the periods of amortization to determine whether later events and circumstances warrant revised estimates.

Stock Based Compensation - The Company accounts for its stock option and stock award plans under Statement of Financial Accounting Standards ("SFAS") No. 123, "Accounting For Stock-Based Compensation". This Statement establishes financial accounting and reporting standards for stock-based compensation plans. These standards include the recognition of compensation expense over the vesting period of the fair value of all stock-based awards on the date of grant. Alternatively, SFAS No 123 also permits entities to continue to apply the provisions of APB No. 25, Accounting For Stock Issued To Employees, and provide pro forma net earnings (loss) and pro forma net earnings (loss) per share disclosures as if the fair value based method defined in SFAS No. 123 had been applied. The Company has elected to continue to apply the provisions of APB No. 25, using the intrinsic value method of accounting for stock based compensation, and provide the pro forma disclosure requirements of SFAS No. 123 in the footnotes to its audited financial statements.

Employee Stock Ownership Plan ("ESOP") - The Company accounts for shares acquired by its ESOP in accordance with the guidelines established by the American Institute of Certified Public Accountants Statement of Position 93-6, Employers' Accounting for Employee Stock Ownership Plans ("SOP 93-6"). Under SOP 93-6, the Company recognizes compensation cost equal to the fair value of the ESOP shares during the periods in which they become committed to be released. To the extent that the fair value of the Company's ESOP shares committed to be released differ from the cost of such shares, the differential is charged or credited to equity. Employers with internally leveraged ESOPs such as the Company do not report the loan receivable from the ESOP as an asset and do not report the ESOP debt from the employer as a liability. The Company's ESOP is a tax-qualified plan. Non-vested shares owned by the ESOP are accounted for via a contra-equity account based upon historic cost. ESOP shares that have not been committed to be released (uncommitted shares) are excluded from outstanding shares on a weighted average basis for earnings per share calculations.

Income Taxes - The Company accounts for income taxes under the liability method. Under this method, deferred tax assets and deferred tax liabilities are recognized for future tax consequences attributable to temporary differences between the financial statement carrying amounts of certain existing assets and liabilities, and their respective bases for Federal income and California franchise taxes. Deferred tax assets and liabilities are calculated by applying current effective tax rates against future deductible or taxable amounts. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in operations in the period that includes the enactment date. Future tax benefits attributable to temporary differences are recognized to the extent the realization of such benefits is more likely than not.

Commissions From Sales Of Non-FDIC Insured Products - The Company realizes commissions from the sales of various non-FDIC insured products, including mutual funds, annuities, and specific securities, as a result of business conducted through Portola. Commission income is typically based upon a percentage of sales. Periodic commission income varies based on the volume and mix of investment products sold, and is recognized on a cash basis.

Earnings Per Share - The Company calculates and discloses basic earnings per share and diluted earnings per share. Basic earnings per share excludes dilution and is computed by dividing net income available to common shareholders by the weighted average number of common shares outstanding during the period. Diluted earnings per share reflects the potential dilution that could occur if contracts to issue common stock or securities convertible into common stock were exercised or converted. Dilution resulting from the Company's stock option and stock award plans is calculated using the treasury stock method.

Comprehensive Income - Comprehensive income includes (i) net income and (ii) other comprehensive income. The Company's only source of other comprehensive income is derived from unrealized gains and losses on securities available for sale. The Company displays comprehensive income within the Consolidated Statements of Changes in Stockholders' Equity. Reclassification adjustments result from gains or losses on securities that were realized and included in net income of the current period that also had been included in other comprehensive income as unrealized holding gains or losses in the period in which they arose. Such adjustments are excluded from current period comprehensive income in order to avoid double counting.

Derivative Instruments And Hedging Activities - Effective January 1, 2001, the Company adopted Statement of Financial Accounting Standards ("SFAS") No 133, "Accounting for Derivative Instruments and hedging Activities", which establishes accounting and reporting standards for derivative instruments and hedging activities. The adoption of this statement did not have any impact on the Company's consolidated financial position or results of operations or cash flows. The Company did not enter into freestanding derivative contracts during 2001 and did not identify any embedded derivatives requiring bifurcation and separate valuation at December 31, 2001.

Segment Disclosure - The Company operates a single line of business (financial services) with no customer accounting for more than 10.0% of its revenue and manages its operation under a unified management and reporting structure. Therefore, no additional segment disclosures are provided.

Reclassifications - Certain reclassifications have been made to prior period financial statements to conform them to the current year presentation.

Recent Accounting Developments

In June 2001, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standard (SFAS) No. 141, "Business Combinations", and SFAS No.142, "Goodwill and Other Intangible Assets". SFAS No. 141 requires that all business combinations initiated after June 30, 2001 be accounted for under the purchase method of accounting and addresses the initial recognition and measurement of goodwill and other intangible assets acquired in a business combination. SFAS No. 142 addresses the initial recognition and measurement of intangible assets acquired outside of a business combination whether acquired individually or with a group of other assets. SFAS No. 142 also addresses the recognition and measurement of goodwill and other intangibles assets subsequent to their acquisition. SFAS No. 142 provides that intangible assets with finite useful lives will be amortized and that goodwill and intangible assets with indefinite lives will not be amortized, but will be required to be tested at least annually for impairment. The Company is required to adopt SFAS No. 142 beginning January 1, 2002. Early adoption is not permitted. The Company does not expect the adoption of SFAS No. 142 to have a material effect on its financial position, results of operations, or cash flows, as the Company had no goodwill as of December 31, 2001 and as all of the Company's intangible assets at December 31, 2001 were comprised of core deposit intangibles that will continue to amortize.

In August 2001, the Financial Accounting Standards Board ("FASB") approved for issuance Statement of Financial Accounting Standard (SFAS) No. 144, "Accounting For The Impairment Or Disposal Of Long-Lived Assets". SFAS No. 144 supersedes SFAS No. 121, "Accounting For The Impairment Of Long-Lived Assets And For Long-Lived Assets To Be Disposed Of" and the accounting and reporting provisions of Accounting Principles Board ("APB") Opinion No. 30, "Reporting The Results Of Operations - Reporting The Effects Of Disposal Of A Segment Of A Business, And Extraordinary, Unusual and Infrequently Occurring Events And Transactions". SFAS No. 144 unifies the accounting treatment for various types of long-lived assets to be disposed of, and resolves implementation issues related to SFAS No. 121. SFAS No. 144 is effective for financial statements issued for fiscal years beginning after December 15, 2001, and interim periods within those fiscal years. The Company will adopt SFAS No. 144 beginning January 1, 2002. The Company does not expect the adoption of SFAS No. 144 to have a material effect on its financial position, results of operations, or cash flows, as the Company had no long-lived assets that were impaired or that were to be disposed of as of December 31, 2001.

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MONTEREY BAY BANCORP, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
YEARS ENDED DECEMBER 31, 2001, 2000, AND 1999 (Continued)

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2. CASH AND CASH EQUIVALENTS

Cash and cash equivalents are summarized as follows:

	December 31, 2001	December 31, 2000
	(Dollars In Thousands)	
Cash on hand	$ 1,444	$ 1,483
Due from banks	10,891	13,544
Certificates of deposit	194	187
Federal funds sold	550	6,735
Money market mutual funds	--	3,210
	$13,079	$25,159

3. INVESTMENT SECURITIES

The amortized cost and estimated fair value of investment securities are presented below. All securities held are publicly traded.

	December 31, 2001		
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses

		(Dollars In Thousands)	
Available for sale			
Variable rate corporate trust preferred securities	$ 7,707	$ --	$ (407)

	December 31, 2000		
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses
		(Dollars In Thousands)	
Available for sale			
Variable rate corporate trust preferred securities	$ 7,696	$ --	$ (336)

The following table shows the amortized cost, estimated fair value, and weighted average yield of the Company's investment securities by year of contractual maturity. Actual maturities may differ from contractual maturities due to rights of issuers to call obligations.

	December 31, 2001		
	Amortized Cost	Estimated Fair Value	Weighted Average Yield
		(Dollars In Thousands)	
Available for sale			
Variable rate corporate trust preferred securities			
Due in 2012 and thereafter	$ 7,707	$ 7,300	2.94%

Proceeds from and realized gains and losses on sales of investment securities available for sale are summarized as follows:

Year Ended December 31,		
2001	2000	1999
	(Dollars In Thousands)	

Proceeds from sales	$ --	$ 3,730	$ 8,005
Gross realized gains on sales	--	--	518
Gross realized losses on sales	--	44	--

4. MORTGAGE BACKED SECURITIES

The amortized cost and estimated fair value of mortgage backed securities ("MBS") are presented below. Types of mortgage backed securities include pass through certificates ("PT's"), balloon MBS ("Balloon's"), and collateralized mortgage obligations ("CMO's"). All securities held are publicly traded.

	December 31, 2001		
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses
		(Dollars In Thousands)	
Available for sale			
Fixed rate FHLMC PT's	$ 1,551	$ 34	$ --
Fixed rate FNMA PT's	585	38	--
Fixed rate GNMA PT's	744	31	--
Variable rate FNMA PT's	4,629	62	--
Fixed rate FHLMC balloons	1,956	--	--
Fixed rate CMO's:			
Agency issuance	17,062	86	--
Non Agency issuance	3,831	35	--
	$30,358	$ 286	$ --

	December 31, 2000		
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses
		(Dollars In Thousands)	
Available for sale			
Fixed rate FHLMC PT's	$ 1,090	$ 13	$ --
Fixed rate FNMA PT's	3,649	25	(2)
Fixed rate GNMA PT's	1,060	--	(11)
Variable rate FNMA PT's	571	5	--
Fixed rate CMOs:			
Agency issuance	19,095	5	(266)
Non Agency issuance	18,210	4	(498)
	$43,675	$ 52	$ (777)

MONTEREY BAY BANCORP, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
YEARS ENDED DECEMBER 31, 2001, 2000, AND 1999 (Continued)

The following table shows the amortized cost, estimated fair value, and weighted average yield of the Company's mortgage backed securities by year of contractual maturity. Actual maturities may differ from contractual maturities due to principal prepayments, priority of principal allocation within collateralized mortgage obligations, or rights of issuers to call obligations prior to maturity.

	December 31, 2001		
	Amortized Cost	Estimated Fair Value	Weighted Average Yield
	(Dollars In Thousands)		
Available for sale			
Due in 2003 through 2006	$ 900	$ 907	5.90%
Due in 2007 through 2011	2,557	2,582	5.28%
Due in 2012 and thereafter	26,901	27,155	4.99%
	$30,358	$30,644	5.04%

Proceeds from and realized gains and losses on sales of mortgage backed securities available for sale are summarized as follows:

	Year Ended December 31,		
	2001	2000	1999
	(Dollars In Thousands)		
Proceeds from sales	$ 12,287	$ 24,425	$ 17,643
Gross realized gains on sales	190	72	30
Gross realized losses on sales	--	83	52

The Company pledges mortgage backed securities to the Federal Home Loan Bank as collateral for advances, to the State of California as collateral for certain deposits, to public entities as collateral for certain deposits, and to the Federal Reserve as collateral for certain customer payments. The following table details the amortized cost of mortgage backed securities not pledged and pledged for various purposes:

	December 31,	
	2001	2000
	(Dollars In Thousands)	

Not pledged	$ --	$ 7,010
Pledged to the Federal Home Loan Bank	3,831	18,210
Pledged to the State of California	24,962	17,487
Pledged to public funds	470	571
Pledged to the Federal Reserve	1,095	397
	$ 30,358	$ 43,675

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MONTEREY BAY BANCORP, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
YEARS ENDED DECEMBER 31, 2001, 2000, AND 1999 (Continued)

5. LOANS RECEIVABLE AND ALLOWANCE FOR LOAN LOSSES

Loans receivable, net are summarized as follows:

	December 3
	2001
	(Dollars In T
Held for investment:	
Loans secured by real estate:	
Residential one to four unit	$204,829
Multifamily five or more units	103,854
Commercial and industrial	109,988
Construction	38,522
Land	11,924
Sub-total loans secured by real estate	469,117
Other loans:	
Home equity lines of credit	6,608
Loans secured by deposits	202
Consumer lines of credit, unsecured	170
Business term loans	3,163
Business lines of credit	5,680
Sub-total other loans	15,823
Sub-total gross loans held for investment	484,940
(Less) / Plus:	
Undisbursed construction loan funds	(12,621)
Unamortized purchase premiums, net of purchase discounts	435
Deferred loan fees and costs, net	(202)
Allowance for loan losses	(6,665)
Loans receivable held for investment, net	$465,887

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MONTEREY BAY BANCORP, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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The Company serviced various types of loans for others, primarily residential mortgages, with the outstanding principal balance amounts summarized below:

	December 31, 2001	2000	1999
	(Dollars In Thousands)		
Loans serviced for others	$ 42,637	$ 62,031	$ 74,225

Activity in the allowance for loan losses is summarized as follows:

	Year Ended December 2001	2000
	(Dollars In Thousands	
Balance, beginning of year	$ 5,364	$ 3,502
Provision for loan losses	1,400	2,175
Charge-offs:		
Residential one to four unit real estate loans	--	(371)
Consumer lines of credit, unsecured	(4)	--
Business lines of credit	(95)	--
Total charge-offs	(99)	(371)
Recoveries:		
Residential one to four family real estate loans	--	58
Balance, end of year	$ 6,665	$ 5,364

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
YEARS ENDED DECEMBER 31, 2001, 2000, AND 1999 (Continued)

The following tables summarizes the Company's recorded investment in impaired loans by type:

	Accrual Status		Non-Accrual Status	
	Principal	Specific Allowances	Principal	Specific Allowances
			(Dollars In Thousands)	
December 31, 2001				
Residential one to four unit	$ --	$ --	$ 1,372	$ --
Commercial real estate	--	--	851	--
Consumer lines of credit	--	--	1	--
Business term loans	--	--	28	--
Total	$ --	$ --	$ 2,252	$ ---
December 31, 2000				
Residential one to four unit	$ 677	$ --	$ 603	$ --
Commercial real estate	--	--	1,133	--
Construction	--	--	2,852	600
Business term loans	--	--	78	--
Total	$ 677	$ --	$ 4,666	$ 600

Additional information concerning impaired loans is as follows:

	2001	2000	1999
	(Dollars In Thousands)		
Average investment in impaired loans for the year	$2,304	$7,790	$2,511
Interest recognized on impaired loans at December 31	$ 146	$ 461	$ 590
Interest not recognized on impaired loans at December 31	$ 46	$ 110	$ 109

Additional information concerning non-accrual loans is as follows:

	2001	2000	1999
	(Dollars In Thousands)		
Interest recognized on non-accrual loans at December 31	$146	$400	$ 80

Interest not recognized on non-accrual loans at December 31	$ 46	$110	$109

The Company extends loans to executive officers and directors in the ordinary course of business. These transactions were on substantially the same terms as those prevailing at the time for comparable transactions with unrelated parties and do not involve more than normal risk or unfavorable terms for the Company. An analysis of the activity of these loans is as follows:

	Year Ended December 31,	
	2001	2000
	(Dollars In Thousands)	
Credit commitments, beginning of year	$ 1,724	$ 631
New term loans and lines of credit	1,781	2,119
Repayments	(1,195)	(728)
Other	(350)	(298)
Credit commitments, end of year	$ 1,960	$ 1,724

Under Office of Thrift Supervision ("OTS") regulations, the Bank may not make real estate loans to one borrower in an amount exceeding 15% of the Bank's unimpaired capital and surplus, plus an additional 10% for loans secured by readily marketable collateral. At December 31, 2001 and 2000, such limitation would have been approximately $7,623,000 and $6,520,000, respectively.

The vast majority of the Company's loans are secured by real estate located in California. The Company's credit risk is therefore primarily related to the economic conditions and real estate valuations of this state. Loans are generally made on the basis of a secure repayment source, which is based on a detailed cash flow analysis; however, collateral is generally a secondary source for loan qualification. Under the Company's policy, private mortgage insurance is required for all residential real estate secured loans with an initial loan to value ratio greater than 80%.

6. INVESTMENT IN CAPITAL STOCK OF THE FEDERAL HOME LOAN BANK

As a member of the Federal Home Loan Bank of San Francisco, the Bank is required to own capital stock in an amount specified by regulation. As of December 31, 2001 and 2000, the Bank owned 29,977 and 28,838 shares, respectively, of $100 par value FHLB stock. The amount of stock owned at December 31, 2001 meets the most recent regulatory determination.

7. ACCRUED INTEREST RECEIVABLE

Accrued interest receivable is summarized as follows:

	December 31, 2001	December 31, 2000
	(Dollars In Thousands)	
Interest receivable on cash equivalents	$ --	$ 13
Interest receivable on investment securities	39	102
Interest receivable on mortgage backed securities	161	246
Interest receivable on capital stock of the Federal Home Loan Bank	29	48
Interest receivable on loans	2,686	2,492
	$2,915	$2,901

8. PREMISES AND EQUIPMENT

Premises and equipment consisted of the following:

	December 31, 2001	December 31, 2000
	(Dollars In Thousands)	
Land	$ 3,213	$ 3,213
Buildings and improvements	4,257	4,373
Equipment	3,733	2,832
Total, at cost	11,203	10,418
Less accumulated depreciation	(3,585)	(3,043)
Premises and equipment, net	$ 7,618	$ 7,375

Depreciation expense was $663 thousand, $441 thousand, and $472 thousand for the years ended December 31, 2001, 2000, and 1999, respectively.

9. CORE DEPOSIT INTANGIBLES

Core deposit intangibles, net, totaled approximately $1.5 million at December 31, 2001. This balance was comprised of two assets that were generated as a result of the purchase of deposit accounts by the Bank from other financial institutions in December 1996 and April 1998. Each of these assets is being amortized on a straight-line basis over seven years. At December 31, 2001, the Company maintained no other intangible assets, including goodwill.

Additional information regarding the Company's core deposit intangibles is as follows:

	Original Carrying Amount	Accumulated Amortization	Cu Car A
	(Dollars In Thousands)		
1996 Core Deposit Intangible			
Balance at December 31, 2000	$ 3,670	$ 2,141	$
2001 amortization expense		524	
Balance at December 31, 2001	$ 3,670	$ 2,665	$
1998 Core Deposit Intangible			
Balance at December 31, 2000	$ 1,096	$ 430	
2001 amortization expense		157	
Balance at December 31, 2001	$1,096	$ 587	
Total Core Deposit Intangibles			
Balance at December 31, 2000	$ 4,766	$ 2,571	$
2001 amortization expense		681	
Balance at December 31, 2001	$ 4,766	$ 3,252	$

Estimated future amortization expense for the Company's core deposit intangibles as of December 31, 2001 is as follows:

	1996 Deposit Acquisition	1998 Deposit Acquisition	Total
	(Dollars In Thousands)		
2002	$ 524	$ 157	$ 681
2003	481	157	638
2004	--	157	157
2005	--	38	38
2006	--	--	--
Total	$ 1,005	$ 509	$ 1,514

MONTEREY BAY BANCORP, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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10. DEPOSITS

Deposits are as follows:

(Dollars In Thousands)	December 31, 2001	December 31, 2000
Demand deposit accounts	$ 21,062	$ 17,065
NOW accounts	42,557	41,859
Savings accounts	19,127	16,503
Money market accounts	105,828	87,651
Certificates of deposit <$100,000	156,351	166,905
Certificates of deposit $100,000 or more	87,414	77,805
	$432,339	$407,788

The following table sets forth the maturity distribution of certificates of deposit:

	December 31, 2001	
	Balance Less Than $100,000	Balance $100,000 And Over
	(Dollars In Thousands)	
Three months or less	$ 44,749	$ 36,273
Over three through six months	37,684	15,944
Over six through twelve months	40,313	18,100
Over twelve months through two years	27,634	14,996
Over two years through three years	2,619	911
Over three years	3,352	1,190
	$ 156,351	$ 87,414

At December 31, 2001 and 2000, respectively, total accounts with balances of $100,000 or greater in deposit products other than certificates of deposit amounted to $72,814,000 and $52,447,000.

Interest expense on deposits is summarized as follows:

	Year Ended December 31,		
	2001	2000	1999
	(Dollars In Thousands)		

NOW accounts	$ 366	$ 550	$ 388
Savings accounts	216	281	280
Money market accounts	3,452	4,040	3,402
Certificates of deposit	12,415	12,360	11,060
	$16,449	$17,231	$15,130

11. ADVANCES FROM THE FEDERAL HOME LOAN BANK AND OTHER BORROWINGS

The Bank is a member of the Federal Home Loan Bank ("FHLB") of San Francisco and borrows from the FHLB through various types of collateralized advances. Assets pledged to the FHLB to collateralize advances include the Bank's ownership interest in the capital stock of the FHLB, mortgage backed securities, and various types of qualifying whole loans.

A summary of advances from the FHLB and related maturities follows. All FHLB advances outstanding at December 31, 2001 and December 31, 2000 were term, bullet maturity, and non-structured advances.

	December 31,	
Year Of Maturity	2001	2000
	(Dollars In Thousands)	
2002	$ 13,000	$ --
2003	33,000	25,000
2004	282	282
2005	1,500	1,500
2006	4,800	4,800
2010	1,000	1,000
	$53,582	$32,582
Weighted average nominal rate	4.46%	5.48%

Additional information concerning advances from the FHLB includes:

	2001	2
	(Dollars In Thou	
Average amount outstanding during the year	$47,526	$43
Maximum amount outstanding at any month-end during the year	$65,582	$50
Weighted average interest rate during the year	5.30%	5

Collateral pledged to secured advances from the FHLB is comprised of the following (amortized cost):

	December 31,	
	2001	2000
	(Dollars In Thousands)	
Mortgage backed securities	$ 3,831	$ 18,210
Capital stock in the Federal Home Loan Bank	2,998	2,884
Mortgage loans	279,539	232,604

Other borrowings at December 31, 2001 included certain impound accounts totaling $218 thousand that bear interest at a rate of 2.00%. These accounts are used to pay various costs associated with real property, including property taxes and insurance.

12. LINES OF CREDIT

At December 31, 2001, Monterey Bay Bancorp, Inc. had a revolving line of credit from a correspondent bank of Monterey Bay Bank. The line of credit is for $3.0 million and expires on December 30, 2002. There was no balance outstanding on the line of credit at December 31, 2001. The line of credit is collateralized by eight hundred thousand shares of Monterey Bay Bancorp, Inc.'s treasury stock, which is in the custody of the correspondent bank. The line of credit contains various covenants regarding the maintenance of certain financial conditions and the provision of financial and operating information. This line of credit provides an additional source of liquidity to the Monterey Bay Bancorp, Inc. holding company.

13. INCOME TAXES

The components of the provision for income taxes are as follows:

	Year Ended December	
	2001	2000
	(Dollars In Thousands)	
Current:		
Federal	$ 2,544	$ 1,889
State	764	652
Total current	3,308	2,541

Deferred:		
Federal	(495)	(457)
State	(26)	(138)
Total deferred	(521)	(595)
Provision for income taxes	$ 2,787	$ 1,946

A reconciliation from the statutory federal income and state franchise tax rates to the consolidated effective tax rates, expressed as a percentage of income before income taxes, follows:

	Year Ended	
	2001	2000
	(Dollars In	
Statutory federal income tax rate	34.0%	34.0%
California franchise tax, net of federal income tax benefit	7.4%	7.6%
Other	1.2%	1.9%
Effective income tax rate	42.6%	43.5%

Deferred income taxes reflect the net tax effects of temporary differences, between the carrying amount of assets and liabilities for financial reporting purposes and the amount used for income tax purposes. Net deferred tax assets are included within other assets on the Consolidated Statements of Financial Condition. The tax effects of temporary differences that gave rise to significant portions of the deferred tax assets and liabilities are as follows:

	December 31,	
	2001	2000
	(Dollars In Thousands)	
Deferred tax assets:		
Allowance for loan losses	$ 2,706	$ 1,864
Intangible assets	1,057	969

Deferred compensation	46	319
Unrealized loss on securities available for sale	50	437
Other	41	75
Total gross deferred tax assets	4,000	3,664
Deferred tax liabilities:		
FHLB stock dividends	(441)	(419
Other	(245)	(66
Total gross deferred tax liabilities	(686)	(485
Net deferred tax asset	$ 3,314	$ 3,179

The Company believes that it is more likely than not that it will realize the above deferred tax assets in future periods; therefore, no valuation allowance has been provided against its deferred tax assets.

Legislation regarding bad debt recapture became law in 1996. The law requires recapture of reserves accumulated after 1987, and required that the recapture tax on post-1987 reserves be paid over a six year period starting in 1996. The Company completed this recapture in 2001.

The Bank maintains a tax bad debt reserve of approximately $5.0 million that arose in tax years that began prior to December 31, 1987. This tax bad debt reserve will, in future years, be subject to recapture in whole or in part upon the occurrence of certain events, including, but not limited to:

- a distribution to stockholders in excess of the Bank's current and accumulated post-1951 earnings and profits

- distributions to shareholders in a partial or complete redemption or liquidation of the Bank

- the Bank ceases to be a "bank" or "thrift" as defined under the Internal Revenue Code

The Bank does not intend to make distributions to stockholders that would result in recapture of any portion of its tax bad debt reserve if such recapture would create an additional tax liability. As a result, an associated deferred tax liability has not been recorded for the $5.0 million pre-1988 tax bad debt reserve.

14. REGULATORY CAPITAL REQUIREMENTS AND OTHER REGULATORY MATTERS

The Bank is subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can result in certain mandatory, and possibly additional discretionary, actions by regulators that, if undertaken, could present a direct material effect upon the Bank's and the Company's financial statements.

The OTS maintains regulations that require the Bank to maintain a minimum regulatory tangible capital ratio (as defined) of 1.50%, a minimum regulatory core capital ratio (as defined) of 4.00% (unless the Bank has been assigned the highest composite rating under the Uniform Financial Institutions Rating System, in which case 3.00%), and a regulatory risk based capital ratio (as defined) of 8.00%. The following table presents a reconciliation as of December 31, 2001 and 2000, between the Bank's capital under accounting principles generally accepted in the United States of America ("GAAP") and regulatory capital as presently defined under OTS regulations, in addition to a review of the Bank's compliance with OTS capital requirements:

(Dollars In Thousands)

	Tangible Capital		Core (Tier One) Capital	
As Of December 31, 2001	Amount	Percent	Amount	Percent
Capital of the Bank presented on a GAAP basis	$ 45,597		$ 45,597	
Adjustments to GAAP capital to derive regulatory capital:				
Net unrealized loss on debt securities classified as available for sale	71		71	
Non-qualifying intangible assets	(1,514)		(1,514)	
Qualifying general allowance for loan losses	--		--	
Bank regulatory capital	44,154	8.24%	44,154	8.24%
Less minimum capital requirement	8,040	1.50%	21,440	4.00%
Regulatory capital in excess of minimums	$ 36,114	6.74%	$ 22,714	4.24%
Additional information:				
Bank regulatory total assets	$ 535,998			
Bank regulatory risk based assets	$ 387,892			

(Dollars In Thousands)

	Tangible Capital		Core (Tier One) Capital	
As Of December 31, 2000	Amount	Percent	Amount	Percent
Capital of the Bank presented on a GAAP basis	$ 40,274		$ 40,274	
Adjustments to GAAP capital to derive regulatory capital:				
Net unrealized loss on debt securities classified as available for sale	624		624	
Non-qualifying intangible assets	(2,195)		(2,195)	

Qualifying general allowance for loan losses	--		--	
Bank regulatory capital	38,703	8.03%	38,703	8.03%
Less minimum capital requirement	7,227	1.50%	19,272	4.00%
Regulatory capital in excess of minimums	$ 31,476	6.53%	$ 19,431	4.03%

Additional information:

Bank regulatory total assets	$ 481,795
Bank regulatory risk based assets	$ 351,038

The OTS can take prompt corrective action against thrift institutions such as the Bank in the event the institution fails to meet certain regulatory capital thresholds. The prompt corrective action regulations define five specific capital categories based upon an institution's regulatory capital ratios. These five capital categories, in declining order, are "well capitalized", "adequately capitalized", "undercapitalized", "significantly undercapitalized", and "critically undercapitalized". Institutions categorized as "undercapitalized" or worse are subject to certain restrictions, including the requirement to file a capital plan with the OTS, prohibitions on the payment of dividends and management fees, restrictions on executive compensation, and increased supervisory monitoring, among other things. Other restrictions may be imposed on the institution either by the OTS or by the FDIC, including requirements to raise additional capital, sell assets, or sell the entire institution.

As of December 31, 2001 and 2000, the most recent notification from the OTS categorized the Bank as "well capitalized" under the regulatory framework for prompt corrective action. To be categorized as "well capitalized", the Bank must maintain minimum core capital, tier one risk based, and total risk based capital ratios as presented in the following table. There are no conditions or events since that notification that management believes have changed the Bank's category.

	Actual		For Capital Adeq Purposes
As Of December 31, 2001	Amount	Ratio	Amount
Total Capital (to risk weighted assets)	$ 49,025	12.64%	$ 31,031
Tier One Capital (to risk weighted assets)	44,154	11.38%	N/A
Core Capital (to adjusted tangible assets)	44,154	8.24%	21,440

Tangible Capital (to tangible assets)	44,154	8.24%	8,040

As Of December 31, 2000	Amount	Ratio	Amount
Total Capital (to risk weighted assets)	$ 43,096	12.28%	$ 28,083
Tier One Capital (to risk weighted assets)	38,703	11.03%	N/A
Core Capital (to adjusted tangible assets)	38,703	8.03%	19,272
Tangible Capital (to tangible assets)	38,703	8.03%	7,227

The above amounts for December 31, 2001 and 2000 reflect a 100% risk-based capital category classification for a specific portfolio of residential mortgage loans, as discussed below.

At December 31, 2001, the Bank was under institution specific requirements from the OTS that regulatory capital ratios not decline below their levels at December 31, 1999. At December 31, 2001, the Bank was in compliance with these institution specific requirements and maintained $6.1 million in regulatory capital in excess of these institution specific requirements.

Management believes that, under current regulations, the Bank will continue to meet its minimum capital requirements in the coming year. However, events beyond the control of the Bank, such as changing interest rates or a downturn in the economy and / or real estate markets where the Bank maintains most of its loans, could adversely affect future earnings and, consequently, the ability of the Bank to meet its future minimum regulatory capital requirements.

OTS rules impose certain limitations regarding stock repurchases and redemptions, cash-out mergers, and any other distributions charged against an institution's capital accounts. The payment of dividends by Monterey Bay Bank to Monterey Bay Bancorp, Inc. is subject to OTS regulations. "Safe-harbor" amounts of capital distributions can be made after providing notice to the OTS, but without needing prior approval. For Tier 1 institutions such as the Bank, an application is not required if the total amount of all capital distributions (including any proposed distribution) for any particular calendar year does not exceed net income for the year to date plus the institution's retained net income for the preceding two years, subject to the Bank's remaining classified as at least "adequately capitalized" following the proposed distribution. Distributions beyond this amount are allowed only with the prior approval of the OTS.

Special Residential Loan Pool

During 1998, the Bank purchased a $40.0 million residential mortgage pool comprised of loans that presented a borrower credit profile and / or a loan to value ratio outside of (less favorable than) the Bank's normal underwriting criteria. To mitigate its credit risk for this portfolio, concurrent with the purchase, the Bank obtained a scheduled principal / scheduled interest loan servicing agreement from the seller. Further, this agreement also contains a guaranty by the seller to absorb any principal losses on the portfolio in exchange for the seller's retention of a portion of the loans' yield through loan servicing fees. As a result of obtaining these credit enhancements, the Bank functionally aggregated the credit risk for this loan pool into a single borrower credit risk to the seller / servicer of the loans. The Bank was subsequently informed by the OTS that structuring the purchase in this manner made the transaction an "extension of credit" by the Bank to the seller / servicer, which, by virtue of its size, violated the OTS' "Loans To One Borrower" regulation.

At December 31, 2001, the outstanding principal balance of this mortgage loan pool was $5.6 million, with an additional $0.5 million in December payoffs received from the seller / servicer in January, 2002. While the seller / servicer met all its contractual obligations through December 31, 2001, the Company has allocated certain loan loss reserves due to concerns regarding the potential losses by the seller / servicer in honoring the guaranty, the present delinquency profile of the special residential mortgage pool, and the differential between certain loan principal balances for foreclosed loans and loans in the process of foreclosure and the estimated amounts to be recovered from the sales of such properties.

Because the seller / servicer provides scheduled principal and interest payments regardless of the actual payment performance of the loans and because the seller / servicer absorbs all losses on the disposition of associated foreclosed real estate, the Company reports all loans within the special residential loan pool as performing.

In conjunction with this Special Residential Loan Pool, on March 6, 2000, the Bank received a letter from the OTS mandating that the Bank (i) assign all of the loans in the pool a 100% risk based capital weighting, and (ii) not permit its regulatory capital ratios to decline below the levels existing at December 31, 1999. The Bank has continually complied with both conditions requested by the OTS.

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15. COMMITMENTS AND CONTINGENCIES

The Company is involved in certain legal proceedings arising in the normal course of business. In the opinion of management, the outcomes of such proceedings should not have a material adverse effect on the Company's financial position or results of operations.

The Company 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 represent commitments to originate fixed and variable rate loans, lines of credit, and loans in process, and involve, to varying degrees, elements of interest rate risk and credit risk in excess of the amount recognized in the Consolidated Statements of Financial Condition. The Company uses the same credit policies in making commitments to originate loans and lines of credit as it does for on-balance sheet instruments.

At December 31, 2001, the Company had outstanding the following commitments to originate loans and lines of credit:

(Dollars In Thousands) Loan Category	December 31, 2001 Outstanding Commitments
Residential fixed rate mortgages	$ 3,239
Residential variable rate mortgages	7,542
Multifamily five or more units	3,480
Commercial and industrial real estate	1,315
Construction	4,377
Land	100
Home equity lines of credit	238
Business term loans	1,096
Business lines of credit	3,030
Total	$ 24,417

Commitments to fund loans are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have expiration dates or other termination clauses. In addition, external market forces may impact the probability of commitments being exercised; therefore, total commitments outstanding do not necessarily represent future cash requirements.

At December 31, 2001, the Company had optional commitments totaling $2.2 million to sell fixed rate residential mortgages to various secondary market purchasers on a servicing released basis. These optional commitments do not expose the Company to financial loss in the event of non-delivery.

At December 31, 2001, the Company had made available various business, personal, and residential lines of credit totaling $25.8 million, of which the undisbursed portion was $13.5 million.

Standby letters of credit are conditional commitments issued by the Company to guarantee the performance of a customer to a third party. At December 31, 2001, the Company maintained no outstanding letters of credit, compared to $136 thousand outstanding at December 31, 2000.

At December 31, 2001, the Company had recourse liability on $895 thousand of sold residential loans. No losses stemming from this recourse liability were recorded during 2001 or 2000. Management includes a consideration of this recourse liability in establishing the allowance for loan losses.

At December 31, 2001, 2000, and 1999, the Company was obligated under non-cancelable operating leases for office space. Certain leases contain escalation clauses providing for increased rentals based primarily on increases in real estate taxes or on the average consumer price index. Rent expense under operating leases, included in occupancy and equipment expense, was $136 thousand, $133 thousand, and $121 thousand for the years ended December 31, 2001, 2000, and 1999, respectively.

Certain branch offices are leased under the terms of operating leases expiring at various dates through the year 2005. At December 31, 2001, future minimum rental commitments under non-cancelable operating leases were as follows:

	(Dollars In Thousands)
2002	$ 138
2003	114
2004	64
2005	32
2006	--
Thereafter	--
Total	$ 348

At December 31, 2001, the Company sub-leased space within its facilities to a total of four parties. Three of these parties were on month to month leases at December 31, 2001. The following table presents the scheduled rent obligation by the fourth party under a non-cancelable operating lease:

	(Dollars In Thousands)
2002	$ 75
2003	77
2004	80
2005	68
2006	--
Thereafter	--
Total	$ 300

In the normal course of business, the Company and Bank have negotiated employment agreements with the Chief Executive Officer / President and the Chief Financial Officer / Treasurer.

In addition, at December 31, 2001, the Company and Bank also maintained change in control agreements with five officers. These agreements result in severance payments following certain events associated with a change in control of the Company or the Bank.

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16. EARNINGS PER SHARE

Basic Earnings Per Share ("EPS") are computed by dividing net income available to common stockholders by the weighted average number of common shares outstanding during each period. During the years 1999 through 2001, all of the Company's net income was available to common stockholders. The weighted average number of common shares outstanding for the Company is decreased in each reporting period by:

- shares associated with the Company's ESOP which have not been committed to be released

- shares associated with the Company's stock grant programs which are not yet vested to Plan participants

- the weighted average number of Treasury shares maintained by the Company during each period

The computation of Diluted EPS also considers, via the treasury stock method of calculation, the impact of shares issuable upon the assumed exercise of outstanding stock options (both incentive stock options and non-statutory stock options) and stemming from the grant of time-based stock awards under the Company's associated Plans for officers and directors. In calculating diluted earnings per share, no anti-dilutive calculations are permitted and diluted share counts are applicable only in the event of positive earnings. For the years 1999 through 2001, there was no difference in the Company's income used in calculating basic and diluted earnings per share.

The following table reconciles the calculation of the Company's Basic and Diluted EPS for the periods indicated.

(In Whole Dollars And Whole Shares)	For The Year Ended 2001	2000
Net income	$ 3,751,000	$ 2,523,000
Average shares issued	4,492,085	4,492,085
Less weighted average:		
Uncommitted ESOP shares	(125,781)	(161,719
Non-vested stock award shares	(28,413)	(60,612
Treasury shares	(1,062,588)	(1,158,844
Sub-total	(1,216,782)	(1,381,175
Weighted average BASIC shares outstanding	3,275,303	3,110,910
Add dilutive effect of:		
Stock options	67,121	12,483
Stock awards	809	159
Sub-total	67,930	12,642
Weighted average DILUTED shares outstanding	3,343,233	3,123,552
Earnings per share:		
BASIC	$ 1.15	$ 0.81
DILUTED	$ 1.12	$ 0.81

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17. OTHER COMPREHENSIVE INCOME

The Company's only source of other comprehensive income has been derived from unrealized gains and losses on the portfolios of investment and mortgage backed securities classified as available for sale.

Reclassification adjustments for the change in net gains (losses) included in other comprehensive income from investment and mortgage backed securities classified as available for sale during the past three years are summarized as follows:

	Year Ended	
	2001	2000
	(Dollars In T	
Gross reclassification adjustment	$ 190	$ (55
Tax (expense) benefit	(78)	23
Reclassification adjustment, net of tax	$ 112	$ (32

A reconciliation of the net unrealized gain or loss on available for sale securities recognized in other comprehensive income is as follows:

	Year E
	2001
	(Dollar
Holding gain (loss) arising during the year, net of tax	$ 665
Reclassification adjustment, net of tax	(112)
Net unrealized gain (loss) recognized in other comprehensive income	$ 553

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18. STOCK BENEFIT PLANS

Stock Option Programs - The Company's stock option programs have all been approved by the Company's stockholders and provide for the issuance of options to directors and employees only, and not to any unaffiliated individuals or entities.

On August 24, 1995, the stockholders of the Company approved the 1995 Incentive Stock Option Plan (the "Stock Option Plan"). Under the Stock Option Plan, the Company may grant to officers and employees of the Company and its subsidiary, the Bank, both non-statutory and incentive stock options, as defined under the Internal Revenue Code, to purchase shares of the Company's common stock.

On August 24, 1995, the stockholders of the Company also approved the 1995 Stock Option Plan For Outside Directors (the "Directors Option Plan"). Under the Directors' Option Plan, directors who are not officers or employees of the Company or Bank may be granted non-statutory stock options to purchase up to 97,929 shares of the Company's common stock.

On May 25, 2000, the stockholders of the Company approved amendments to the Stock Option Plan. These amendments included:

- an increase in the number of shares reserved for issuance under the Stock Option Plan to 660,000 shares

- an increase in the strike price of options granted under the Stock Option Plan from not less than 100% of the fair market value of the common stock on the date of grant (except that the exercise price for beneficial owners of more than 10.0% of the outstanding voting stock of the Company must be equal to 110% of the fair market value of the common stock on the date of grant) to at least 110% of the fair market value of the common stock on the date of grant for all grants occurring on or after May 25, 2000

- providing additional flexibility in the vesting schedule for both incentive stock options and non-statutory stock options

- allowing non-employee directors to be eligible for the grant of non-statutory stock options under the Stock Option Plan

Options granted under the Stock Option Plan prior to May 25, 2000 entitle the holder to purchase one share of the common stock at the fair market value of the common stock on the date of grant. Options granted under the Stock Option Plan prior to May 25, 2000 begin to vest one year after the date of grant ratably over five years and expire no later than ten years after the date of grant.

Options granted under the Stock Option Plan after May 24, 2000 entitle the holder to purchase one share of the common stock at 110% of the fair market value of the common stock on the date of grant. Options granted under the Stock Option Plan after May 24, 2000 vest at various times as specified under each individual option agreement and expire no later than ten years after the date of grant.

Options granted under the Directors Option Plan entitle the holder to purchase one share of the common stock at the fair market value of the common stock on the date of grant. Options begin to vest one year after the date of grant ratably over five years and expire no later than ten years after the date of grant.

As of December 31, 2001, there were 1,500 non-statutory stock options issued under the Stock Option Plan granted to an individual owning more than 10.0% of the Company's common shares then outstanding. However, restrictions contained in the Company's Articles Of Incorporation limit the combined voting power of the Company common stock owned by this individual, who was a Director of the Company at December 31, 2001, to no more than 10.0% of the total combined voting power of the Company's common stock.

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MONTEREY BAY BANCORP, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
YEARS ENDED DECEMBER 31, 2001, 2000, AND 1999 (Continued)

During the years ended December 31, 2001, 2000, and 1999, the Company did not amend the terms or conditions of any existing stock option grant. The Company has never repriced a stock option following its issuance.

All options under the Stock Option Plan become 100% exercisable in the event that the employee terminates his employment due to death, disability, or, to the extent not prohibited by the OTS, in the event of a change in control of the Company or the Bank.

All options under the Directors Option Plan become 100% exercisable in the event that the director terminates membership on the board of directors due to death, disability, or, to the extent not prohibited by the OTS, in the event of a change in control of the Company or the Bank.

The Company applies Accounting Principles Board ("APB") Opinion No. 25 and related interpretations in accounting for stock options. Under APB No. 25, compensation cost for stock options is measured as the excess, if any, of the fair market value of the Company's stock at the date of grant over the amount the employee or director must pay to acquire the stock. Because the Company's stock option Plans provide for the issuance of options at a price of no less than the fair market value at the date of grant, no compensation cost is required to be recognized for the stock option Plans.

Had compensation costs for the stock option Plans been determined based upon the fair value at the date of grant consistent with SFAS No. 123, Accounting For Stock Based Compensation, the Company's net income and earnings per share would have been reduced to the pro forma amounts indicated below. The pro forma amounts presented below were calculated utilizing the Black-Scholes option pricing model, with forfeitures recognized as they occur, incorporating the assumptions detailed on the following page.

	Year Ended December	
	2001	2000
	(Dollars In Thousands, Except Sha	
Net income:		
As reported	$ 3,751	$ 2,523

Pro forma	$ 3,522	$ 2,223
Basic earnings per share:		
As reported	$ 1.15	$ 0.81
Pro forma	$ 1.08	$ 0.71
Diluted earnings per share:		
As reported	$ 1.12	$ 0.81
Pro forma	$ 1.05	$ 0.71
Shares utilized in Basic EPS calculations	3,275,303	3,110,910
Shares utilized in Diluted EPS calculations	3,343,233	3,123,552

The status of the aggregate stock options under the two Plans as of December 31, 2001, 2000, and 1999, and changes during the years then ended, are presented below. The abbreviation "FMV" represents "fair market value" and the abbreviation "N/A" represents "not applicable".

	December 31,			
	2001		2000	
	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
Options outstanding at the beginning of the year	550,236	$10.19	362,597	$10.30
Granted	82,750	$15.19	197,865	$10.00
Forfeited	92,271	$12.03	10,226	$10.49
Exercised	115,611	$9.11	--	$ --
Options outstanding at year end	425,104	$11.02	550,236	$10.19
Options outstanding at year end:				
Granted at 100% FMV	270,354	$9.71	464,236	$10.04
Granted at 110% FMV	154,750	$13.32	86,000	$10.98
Total	425,104	$11.02	550,236	$10.19
Options exercisable at year end:				
Granted at 100% FMV	184,932	$9.65	308,262	$9.65
Granted at 110% FMV	70,292	$14.10	17,240	$11.76
Total	255,224	$10.88	325,502	$9.76

Options available for future grants	137,064	127,543
Weighted average remaining contractual life of options outstanding at year end	6.2 years	6.6 years
Weighted average fair value for options granted during the year at 100% of FMV:	N/A	$4.68
Weighted average fair value for options granted during the year at 110% of FMV:	$5.08	$4.41
Weighted average assumptions utilized in the Black-Scholes option-pricing model for all options granted each year		
Dividend Yield	0.00%	0.00%
Expected stock price volatility	35.00%	35.00%
Average risk-free interest rate	4.44%	6.11%
Expected option lives	6 years	8 years

The following table summarizes information about the stock options outstanding at December 31, 2001:

Options Granted At 100% Of Fair Market Value:

Exercise Price	Number Outstanding	Weighted Average Remaining Contractual Life In Years	Number Exercisable
$ 8.19	45,000	8.3	9,000
$ 9.10	140,616	3.6	140,616
$ 9.50	9,658	4.5	9,658
$ 9.69	9,941	8.2	1,987
$ 10.13	40,000	8.1	8,000
$ 14.80	18,750	6.5	11,250
$ 16.60	6,389	6.2	4,421
$ 8.19 - $16.60	270,354	5.5	184,932

Options Granted At 110% Of Fair Market Value:

Weighted
Average

Exercise Price	Number Outstanding	Remaining Contractual Life In Years	Number Exercisable
$ 9.90	10,000	8.4	2,000
$11.21	42,500	8.9	8,500
$11.76	20,000	4.7	17,792
$12.62	8,000	9.5	--
$12.65	10,000	9.1	--
$14.74	3,000	9.8	--
$15.88	51,250	5.8	42,000
$16.26	3,000	9.7	--
$16.64	5,000	10.0	--
$16.82	2,000	10.0	--
$9.90 - $16.82	154,750	7.4	70,292
TOTAL	425,104	6.2	255,224

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MONTEREY BAY BANCORP, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
YEARS ENDED DECEMBER 31, 2001, 2000, AND 1999 (Continued)

Stock Award Programs - The Company maintains a Performance Equity Program ("PEP") for officers and employees. In addition, prior to the end of 2000, the Company maintained a Recognition and Retention Plan for Outside Directors ("RRP"). The Company accelerated the vesting of the remaining RRP shares, distributed the remaining shares, and terminated the RRP during 2000. These two stock award Plans (PEP and RRP) were designed to provide directors, officers, and employees with a proprietary interest in the Company in a manner designed to encourage such persons to remain with the Company and to improve the financial performance of the Company. The two stock award plans were approved by the Company's stockholders.

The Bank contributed $1.7 million during the fourth quarter of 1995 and the first quarter of 1996 to purchase 179,687 shares of Company common stock in the open market at a weighted average cost of $9.62 per share. This contribution was initially recorded as a reduction in stockholders' equity and then is ratably charged to compensation expense over the vesting period of the actual stock awards. Of the 179,687 shares acquired, 38,010 were allocated to the RRP, with the remaining 141,677 allocated to the PEP.

The PEP provides for two types of stock awards: time-based grants and performance-based grants. Time-based grants vest pro-rata on each anniversary of the grant date and become fully vested over the applicable time period as determined by the board of directors, typically five years. Vesting of performance-based grants is dependent upon achievement of criteria established by the board of directors for each stock award. Under the RRP, outside directors of the Company received exclusively time-based grants.

All stock awards granted will be immediately vested in the event the recipient terminates his employment (or in the case of a director, his service, including service as a Director Emeritus) due to death, disability, or a change in control of Monterey Bay Bank or Monterey Bay Bancorp, Inc. In the event the award recipient terminates his employment or service due to any reason other than death, disability, or a change in control, all unvested stock awards become null and void. In addition, to the extent that criteria for performance-based stock awards are not achieved, associated awards are forfeited and become available for re-issuance.

Periodic operating expense for time-based stock awards is recognized based upon fair market value at date of grant. Periodic operating expense for performance-based stock awards is recognized based upon fair market value at the earlier of the reporting date or the performance measurement date.

During 2001 and 2000, the Company utilized previously unallocated shares under the PEP to compensate certain employees for their favorable performance. These shares were granted in lieu of cash incentive compensation and vested immediately.

During the years ended December 31, 2001, 2000, and 1999, the Company made no changes to the terms or conditions of existing stock award grants.

A summary of the PEP as of December 31, 2001, 2000, and 1999, and changes and related expense during the years ended on those dates, is presented below:

	2001	20
Stock awards outstanding at the beginning of the year	35,079	30,8
Stock award activity during the year:		
Time based shares granted	--	11,5
Performance based shares granted	--	18,1
Performance based shares granted in lieu of cash compensation	9,438	3,1
Performance based shares immediately vested upon grant	(9,438)	(3,1
Time based shares forfeited	(6,329)	
Performance based shares forfeited	(3,109)	(1,1
Time based shares vested	(4,298)	(11,8
Performance based shares vested	(3,374)	(12,5
Stock awards outstanding at the end of the year	17,969	35,0
Available for future awards at the end of the year	--	
PEP compensation expense (Dollars In Thousands)	$ 200	$ 2

A summary of the status of the RRP as of December 31, 2001, 2000, and 1999, and changes and related expense during the years ended on those dates, is presented below:

	2001	2000
Stock awards outstanding at the beginning of the year	--	9,541
Stock award activity during the year:		
Time based shares granted	--	--
Time based shares canceled	--	--
Time based shares vested	--	(9,541)
Stock awards outstanding at the end of the year	--	--
Available for future awards at the end of the year	--	--
RRP compensation expense (Dollars In Thousands)	$ --	$ 66

Employee Stock Ownership Plan and Trust - The Company established for eligible employees an Employee Stock Ownership Plan and Trust ("ESOP"), which became effective upon the conversion of the Bank from a mutual to a stock association. Eligible full-time employees employed with the Bank who have been credited with at least 1,000 hours during a twelve month period, have attained age twenty-one, and were employed on the last business day of the calendar year are eligible to participate.

The ESOP subscribed for 8.0% (or 359,375) of the shares of Company common stock issued in the Conversion at an adjusted price of $6.40 per share. On February 14, 1995, the ESOP borrowed $2.3 million from Monterey Bay Bancorp, Inc. in order to fund the purchase of the common stock. This loan is being repaid pro-rata over an approximately ten year period concluding on December 31, 2004, with the funds for repayment primarily coming from the Bank's contributions to the ESOP over a similar time period. The loan is collateralized by the shares of common stock held by the ESOP.

As an internally leveraged ESOP, no interest income or interest expense is recognized on the loan in the consolidated financial statements of the Company. Annual principal payments of $230,000 are scheduled for the conclusion of each calendar year in conjunction with a release of shares for allocation to individual employee accounts. Shares are allocated on the basis of eligible compensation, as defined in the ESOP plan document, in the year of allocation. Benefits generally become 100% vested after seven years of credited service. Employees with at least three, but fewer than seven, years of credited service receive a partial vesting according to a sliding schedule. However, in the event of retirement, disability, or death, any unvested portion of benefits shall vest immediately. Any share forfeitures are allocated among participating employees in the same proportion as annual share allocations. Benefits are payable upon separation from service based on vesting status and share allocations made.

As of December 31, 2001, 251,562 shares had been cumulatively allocated to participants and committed to be released. As of December 31, 2001, the fair market value of the 107,813 unearned shares was $1.7 million based upon a closing market price per share of $15.50. The outstanding ESOP loan balance, which is not a component of the Company's consolidated financial statements, was $690 thousand at December 31, 2001.

Periodic operating expense associated with the ESOP is recognized based upon:

- the number of Company common shares pro-rata allocated
- the fair market value of the Company's common stock at the dates shares are committed to be released
- any dividends received on unallocated shares as a reduction to periodic operating expense

The benefits expenses, not including administrative costs, related to the ESOP for the years ended December 31, 2001, 2000, and 1999 were $437 thousand, $317 thousand, and $454 thousand, respectively. At December 31, 2001 and 2000, the unearned compensation related to the ESOP was $690 thousand and $920 thousand, respectively. These amounts are shown as a reduction of stockholders' equity in the Consolidated Statements Of Financial Condition.

19. 401(K) PLAN

The Company maintains a tax deferred employee savings plan under Section 401(k) of the Internal Revenue Code. All employees are eligible to participate who are 21 years of age, have been employed by the Company for at least 30 days, and are scheduled to complete 1,000 hours of service or more per calendar year. While the 401(k) Plan allows the Company to provide periodic or matching contributions to employee accounts within the 401(k) Plan, no such contributions were made in the years 1999 through 2001.

The trust that administers the 401(k) Plan had assets of approximately $1.7 million and $1.8 million as of December 31, 2001 and 2000, respectively. None of these assets have been maintained at the Company or its subsidiary. At December 31, 2001, 401(k) Plan participants were able to invest in one or more of a total of twelve different investment alternatives at their discretion. The 401(k) Plan also allows participants to borrow funds, subject to certain limitations.

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MONTEREY BAY BANCORP, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
YEARS ENDED DECEMBER 31, 2001, 2000, AND 1999 (Continued)

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20. PARENT COMPANY ONLY CONDENSED FINANCIAL INFORMATION

The Parent Company (Monterey Bay Bancorp, Inc.) and its subsidiary, the Bank, file consolidated federal income tax returns in which the taxable income or loss of the Parent Company is combined with that of the Bank. The Parent Company's share of income tax expense is based on the amount which would be payable if separate returns were filed. Accordingly, the Parent Company's equity in the net income of its subsidiaries (distributed and undistributed) is excluded from the computation of the provision for income taxes for stand alone financial statement purposes.

The condensed financial statements of Monterey Bay Bancorp, Inc. (parent company only) are as follows:

CONDENSED STATEMENTS OF FINANCIAL CONDITION

	December 31, 2001	December 31, 2000
	(Dollars In Thousands)	
ASSETS:		
Cash and due from depository institutions	$ 4,619	$ 558
Overnight deposits	--	3,210
Total cash & cash equivalents	4,619	3,768
Other assets	1	51
Investment in subsidiary	45,597	40,274
TOTAL ASSETS	$50,217	$44,093
LIABILITIES AND STOCKHOLDERS' EQUITY:		
Liabilities:		
Other liabilities	55	256
Total Liabilities	55	256
Stockholders' equity	50,162	43,837
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$50,217	$44,093

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MONTEREY BAY BANCORP, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
YEARS ENDED DECEMBER 31, 2001, 2000, AND 1999 (Continued)

CONDENSED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME

	Year Ende	
	2001	
	(Dollars	
Interest income:		
Interest on mortgage backed securities and investment securities	$ --	$
Interest on loan receivable	--	

Other interest income	130	
Total interest income	130	
Interest expense:		
Borrowings	9	
Total interest expense	9	
Net interest income before (benefit) provision for loan losses	121	
(Benefit) provision for loan losses	--	
Net interest income after (benefit) provision for loan losses	121	
Loss on sale of mortgage backed securities available for sale	--	
Non-interest expense	612	
Income before (benefit) provision for income taxes	(491)	
(Benefit) provision for income taxes	(202)	
(Loss) income before undistributed net income of subsidiary	(289)	
Undistributed net income of subsidiary	4,040	2
Net income	$3,751	$2
Other comprehensive income (loss)	553	
Total comprehensive income	$4,304	$3

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MONTEREY BAY BANCORP, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
YEARS ENDED DECEMBER 31, 2001, 2000, AND 1999 (Continued)

CONDENSED STATEMENTS OF CASH FLOWS

	Year Ended	
	2001	
	(Dollars	
OPERATING ACTIVITIES:		
Net income	$ 3,751	$ 2

Adjustments to reconcile net income to net cash provided by operating activities:		
Undisbursed net income of subsidiary	(4,040)	(2
Amortization of premiums on securities	--	
(Benefit) provision for loan losses	--	
Loss on sale of securities	--	
Cash receipts associated with ESOP	230	
Decrease (increase) in other assets	50	
Other, net	107	
Net cash provided by operating activities	98	
INVESTING ACTIVITIES:		
Proceeds from repayments of loans	--	5
Investment in subsidiary	(300)	(2
Principal repayments on mortgage backed securities available for sale	--	
Proceeds from sales of mortgage backed securities available for sale	--	3
Net cash (used in) provided by investing activities	(300)	6
FINANCING ACTIVITIES:		
(Repayments) proceeds of borrowings, net	--	(2
Cash dividends paid to stockholders	--	
Sales of treasury stock for exercise of stock options	1,053	
Purchases of treasury stock	--	(1
Net cash provided by (used in) financing activities	1,053	(3
NET INCREASE (DECREASE) IN CASH & CASH EQUIVALENTS	851	3
CASH & CASH EQUIVALENTS AT BEGINNING OF YEAR	3,768	
CASH & CASH EQUIVALENTS AT END OF YEAR	$ 4,619	$ 3

MONTEREY BAY BANCORP, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
YEARS ENDED DECEMBER 31, 2001, 2000, AND 1999 (Continued)

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21. ESTIMATED FAIR VALUES OF FINANCIAL INSTRUMENTS

The estimated fair value amounts have been determined by the Company, using available market information and appropriate valuation methodologies. However, considerable judgement is required to interpret market data to develop the estimates of fair value. Accordingly, the estimates presented herein are not necessarily indicative of the amounts the Company could realize in a current market exchange. The use of different assumptions and / or estimation methodologies may have a material effect on the estimated fair value amounts.

The following methods and assumptions were used by the Company in computing the estimated fair values:

Cash And Cash Equivalents - Current carrying amounts approximate estimated fair value.

Investment Securities and Mortgage Backed Securities - Fair values of these securities are based on year-end market prices or dealer quotes. If quoted market prices are not available, estimated fair values were based upon quoted market prices of comparable instruments.

Loans Receivable Held For Investment - For fair value estimation purposes, these loans have been categorized by type of loan (e.g., one to four unit residential) and then further segmented between adjustable or fixed rates. Where possible, the fair value of these groups of loans has been based on secondary market prices for loans with similar characteristics. The fair value of the remaining loans has been estimated by discounting the future cash flows using current interest rates being offered for loans with similar remaining terms to borrowers of similar credit quality. Prepayment estimates were based on historical experience and published data for similar loans.

Capital Stock Of The Federal Home Loan Bank - Fair value is based upon its redemption value, which equates to current carrying amounts.

Transaction Deposit Accounts - The estimated fair value of checking, savings, and money market deposit accounts is the amount payable on demand at the reporting dates.

Certificates Of Deposit - Fair value has been estimated by discounting the contractual cash flows using current market rates offered in the Company's market area for similar time deposits with comparable remaining terms.

FHLB Advances - Fair value was estimated by discounting the contractual cash flows using current market rates offered for advances with comparable conditions and remaining terms.

Other Borrowings - Current carrying amounts approximate estimated fair value.

Commitments To Extend Credit - The estimated fair values of commitments to fund loans are estimated using the fees currently charged to enter into similar agreements, considering the remaining terms of the agreements and the present creditworthiness of the counterparties. For fixed rate loan commitments, the estimated fair values also incorporate the difference between current levels of interest rates for similar commitments and the committed rates.

Standby Letters Of Credit - The estimated fair values of standby letters of credit were determined by using the fees currently charged taking into consideration the remaining terms of the agreements and the creditworthiness of the counterparties.

The carrying amounts and estimated fair values of the Company's financial instruments are as follows:

	December 31, 2001		D
	Carrying Amount	Estimated Fair Value	C
		(Dollars In Thous	
ASSETS:			
Cash and cash equivalents	$ 13,079	$ 13,079	$
Investment securities available for sale	7,300	7,300	
Mortgage backed securities available for sale	30,644	30,644	
Loans held for sale	713	717	
Loans receivable held for investment, net	465,887	477,117	
FHLB stock	2,998	2,998	
LIABILITIES:			
Transaction deposit accounts	188,574	188,574	
Certificates of deposit	243,765	245,574	
Advances from the Federal Home Loan Bank	53,582	55,165	
Other borrowings	218	218	
OFF-BALANCE SHEET			
Commitments to fund loans	--	--	
Standby letters of credit	--	--	

The fair value estimates presented herein are based upon pertinent information available to management as of December 31, 2001 and 2000. The fair value amounts have not been comprehensively reevaluated since the reporting date. Therefore, current estimates of fair value and the amounts realizable in current secondary market transactions may differ significantly from the amounts presented herein.

22. QUARTERLY RESULTS OF OPERATIONS (UNAUDITED)

The following is a summary of quarterly results:

	First Quarter	Second Quarter	Thir Quarte
	(Dollars In Thousands, Except		
Year Ended December 31, 2001:			

Interest and dividend income	$ 9,996	$ 9,710	$ 9,75
Interest expense	5,244	4,937	4,74
Provision for loan losses	500	300	27
Non-interest income	643	695	69
Non-interest expense	3,843	3,520	3,58
Provision for income taxes	450	699	78
Net income	602	949	1,05
Shares applicable to Basic earnings per share	3,227,241	3,262,003	3,293,85
Basic earnings per share	$ 0.19	$ 0.29	$ 0.3
Shares applicable to Diluted earnings per share	3,274,559	3,300,595	3,385,55
Diluted earnings per share	$ 0.18	$ 0.29	$0.3
Cash dividends paid per share	$ --	$ --	$ -

	First Quarter	Second Quarter	Thir Quarte
	(Dollars In Thousands, Except		
Year Ended December 31, 2000:			
Interest and dividend income	$ 9,050	$ 9,411	$ 9,51
Interest expense	4,557	4,859	5,11
Provision for loan losses	250	775	65
Non-interest income	501	583	63
Non-interest expense	3,337	3,369	3,55
Provision for income taxes	608	437	36
Net income	799	554	46
Shares applicable to Basic earnings per share	3,138,424	3,075,153	3,100,16
Basic earnings per share	$ 0.25	$ 0.18	$ 0.1
Shares applicable to Diluted earnings per share	3,150,825	3,076,403	3,103,79
Diluted earnings per share	$ 0.25	$ 0.18	$0.1
Cash dividends paid per share	$ 0.08	$ --	$ -

Item 9. Changes In And Disagreements With Accountants On Accounting And Financial Disclosure

None.

PART III

Item 10. Directors And Executive Officers Of The Registrant

The information relating to Directors and Executive Officers of the Registrant is incorporated herein by reference to the Registrant's Proxy Statement for the Annual Meeting of Stockholders to be held on May 23, 2002, which will be filed no later than 120 days following Registrant's fiscal year end. Information concerning Executive Officers who are not Directors is also contained in Part I of this report pursuant to paragraph (b) of Item 401 of Regulation S-K in reliance on Instruction G.

Item 11. Executive Compensation

The information relating to Director and Executive Officer compensation is incorporated herein by reference to the Registrant's Proxy Statement for the Annual Meeting of Stockholders to be held on May 23, 2002, excluding the Compensation Committee Report on Executive Compensation and the Stock Performance Graph, which will be filed no later than 120 days following the Registrant's fiscal year end.

Item 12. Security Ownership Of Certain Beneficial Owners And Management.

The information relating to security ownership of certain beneficial owners and management is incorporated herein by reference to the Registrant's Proxy Statement for the Annual Meeting of Stockholders to be held on May 23, 2002, which will be filed no later than 120 days following the Registrant's fiscal year end.

Item 13. Certain Relationships And Related Transactions.

The information relating to certain relationships and related transactions is incorporated herein by reference to the Registrant's Proxy Statement for the Annual Meeting of Stockholders to be held on May 23, 2002, which will be filed no later than 120 days following the Registrant's fiscal year end.

PART IV

Item 14. Exhibits, Financial Statement Schedules, And Reports On Form 8-K.

(a)(1) Financial Statements

The following consolidated financial statements of the Registrant are filed as a part of this document under Item 8, "Financial Statements and Supplementary Data."

Consolidated Statements Of Financial Condition At December 31, 2001 And 2000.

Consolidated Statements of Income For Each Of The Years In The Three Year Period Ended December 31, 2001.

Consolidated Statements Of Changes In Stockholders' Equity For Each Of The Years In The Three Year Period Ended December 31, 2001.

Consolidated Statements Of Cash Flows For Each Of The Years In The Three Year Period Ended December 31, 2001.

Notes To Consolidated Financial Statements.

Independent Auditors' Report.

(a)(2) Financial Statement Schedules

Financial Statement Schedules have been omitted because they are not applicable or the required information is shown in the Consolidated Financial Statements or Notes thereto under Item 8, "Financial Statements and Supplementary Data."

(a)(3) Management Contracts (see Item 14 (c), below)

(b) Reports On Form 8-K Filed During The Last Quarter Of The Registrant's Fiscal Year Ended December 31, 2001

(1) Form 8-K dated October 22, 2001 which includes the announcement of financial and operating results for the three and nine month periods ended September 30, 2001 and the continuing arbitration of claims by a former executive.

(2) Form 8-K dated November 7, 2001 which includes the announcement of the conclusion and results of binding arbitration conducted to address claims by the former President and Chief Operating Officer regarding payments due under his employment contracts.

(3) Form 8-K dated November 20, 2001 which includes the announcement of the resignation of Mr. Nicholas C. Biase from the Board of Directors of the Company and its subsidiary, Monterey Bay Bank.

(4) Form 8-K dated December 21, 2001 which includes the announcement of the Company's adoption of a stock repurchase program, with a total of 114,035 shares authorized for repurchase.

(5) Form 8-K dated January 29, 2002 which includes the announcement of financial and operating results for the quarter and year ended December 31, 2001, the date for the 2002 annual meeting of stockholders, and the record date for voting at the 2002 annual meeting of stockholders.

(6) Form 8-K dated March 15, 2002 that includes the announcement of the establishment of a loan production office in Southern California, the elimination of institution specific regulatory capital requirements, the repurchase of additional shares of the Company's common stock, and the resignation of Susan F. Grill as Director of Retail Banking for Monterey Bay Bank.

(c) Exhibits Required by Securities and Exchange Commission Regulation S-K

Exhibit Number	
3.1	Certificate Of Incorporation Of Monterey Bay Bancorp, Inc. (1)
3.3	Bylaws Of Monterey Bay Bancorp, Inc. As Amended And Restated Effective March 22, 2001 (2)
4.0	Stock Certificate Of Monterey Bay Bancorp, Inc. (1)
10.8	Monterey Bay Bank Employee Severance Compensation Plan (1)

10.9	Monterey Bay Bank 401(k) Plan (1)
10.10	Monterey Bay Bank 1995 Retirement Plan For Executive Officers And Directors. (1)
10.11	Monterey Bay Bank Performance Equity Program (3)
10.12	Monterey Bay Bank Recognition And Retention Plan For Outside Directors (3)
10.13	Monterey Bay Bancorp, Inc. 1995 Incentive Stock Option Plan As Amended And Restated Effective May 25, 2000 (4)
10.14	Monterey Bay Bancorp, Inc. 1995 Stock Option Plan For Outside Directors (3)
10.17	Form Of Amended Change In Control Agreement Between Monterey Bay Bancorp, Inc., Monterey Bay Bank, And Certain Officers Effective March 22, 2001 (2)
10.18	Employment Agreement With C. Edward Holden (5)
10.19	Employment Agreement With Mark R. Andino (5)
10.20	Change In Control Agreement Between Monterey Bay Bancorp, Inc., Monterey Bay Bank, And Susan M. Carlson Effective March 22, 2002
21	Subsidiary information is incorporated herein by reference to "Part I - Subsidiaries"
23	Consent Of Deloitte & Touche LLP, Independent Auditors

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(1) Incorporated herein by reference from the Exhibits to the Registration Statement on Form S-1, as amended, filed on September 21, 1994, Registration No. 33-84272.

(2) Incorporated herein by reference from the Exhibits to the Annual Report on Form 10-K for December 31, 2000 filed on March 22, 2001

(3) Incorporated herein by reference from the Proxy Statement for the Annual Meeting of Stockholders' filed on July 26, 1995.

(4) Incorporated herein by reference from the Proxy Statement for the Annual Meeting of Stockholders' filed on April 14, 2000.

(5) Incorporated herein by reference from the Exhibits to the Quarterly Report on Form 10-Q for March 31, 2001 filed on May 14, 2001.

SIGNATURES

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

MONTEREY BAY BANCORP, INC.

Date: March 28, 2002

By: /s/ C. Edward Holden

C. Edward Holden
Vice Chairman, Director,
Chief Executive Officer, President

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

Name	Title
/s/ McKenzie Moss McKenzie Moss	Chairman of the Board of Directors
/s/ C. Edward Holden C. Edward Holden	Vice Chairman, Director, Chief Executive Officer, President
/s/ Mark R. Andino Mark R. Andino	Chief Financial Officer, Treasurer (Principal Financial and Accounting Officer)
/s/ Josiah T. Austin Josiah T. Austin	Director
/s/ Edward K. Banks Edward K. Banks	Director
/s/ Diane S. Bordoni Diane S. Bordoni	Director
/s/ Larry A. Daniels Larry A. Daniels	Director
/s/ Steven Franich Steven Franich	Director
/s/ Stephen G. Hoffmann Stephen G. Hoffmann	Director
/s/ Gary L. Manfre Gary L. Manfre	Director