

ITLA CAPITAL CORP  
Form 10-Q  
May 10, 2004

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

**FORM 10-Q**

(Mark One)

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

For the Quarterly Period Ended March 31, 2004

OR

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

For the Transition Period from \_\_\_\_\_ to \_\_\_\_\_  
Commission File Number 0-26960

**ITLA CAPITAL CORPORATION**

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(Exact Name of Registrant as Specified in its Charter)

Delaware

95-4596322

\_\_\_\_\_  
(State or Other Jurisdiction of Incorporation or Organization)

\_\_\_\_\_  
(IRS Employer Identification No.)

888 Prospect St., Suite 110, La Jolla, California

92037

\_\_\_\_\_  
(Address of Principal Executive Offices)

\_\_\_\_\_  
(Zip Code)

(858) 551-0511

\_\_\_\_\_  
(Registrant's Telephone Number, Including Area Code)

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

Indicate by check mark whether the Registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes  No .

Number of shares of common stock of the registrant: 6,255,769 outstanding as of May 3, 2004.

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**ITLA CAPITAL CORPORATION**  
**FORM 10-Q**  
**FOR THE THREE MONTHS ENDED MARCH 31, 2004**

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**Forward Looking Statements**

Safe Harbor statement under the Private Securities Litigation Reform Act of 1995: This Form 10-Q contains forward-looking statements that are subject to risks and uncertainties, including, but not limited to, changes in economic conditions in our market areas, changes in policies by regulatory agencies, the impact of competitive loan products, loan demand risks, the quality or composition of our loan or investment portfolios, fluctuations in interest rates and changes in the relative differences between short and long-term interest rates, levels of nonperforming assets and operating results, the impact of terrorist actions on our loan portfolio and loan repayments, and other risks detailed from time to time in our filings with the Securities and Exchange Commission. We caution readers not to place undue reliance on forward-looking statements. We do not undertake and specifically disclaim any obligation to revise any forward-looking statements to reflect the occurrence of anticipated or unanticipated events or circumstances after the date of such statements. These risks could cause our actual results for 2004 and beyond to differ materially from those expressed in any forward-looking statements by, or on behalf of, us.

As used throughout this report, the terms "we", "our", "ITLA Capital" or the "Company" refer to ITLA Capital Corporation and its consolidated subsidiaries.

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**ITLA CAPITAL CORPORATION AND SUBSIDIARIES  
CONSOLIDATED BALANCE SHEETS**

|  | March 31,<br>2004<br>(unaudited) | December 31,<br>2003 |
|--|----------------------------------|----------------------|
| (in thousands except share amounts)  |                                  |                      |
| <b>Assets</b>  |                                  |                      |
| Cash and cash equivalents  | \$ 285,441                       | \$ 178,318           |
| Investment securities available for sale, at fair value  | 49,594                           | 53,093               |
| Stock in Federal Home Loan Bank  | 18,262                           | 17,966               |
| Loans, net (net of allowance for loan losses of \$33,057 and \$31,573 as of March 31, 2004 and December 31, 2003, respectively)  | 1,452,676                        | 1,436,849            |
| Real estate loans held in trust, net (net of allowance for loan losses of \$1,828 as of March 31, 2004 and December 31, 2003)  | 55,604                           | 68,575               |
| Loans held for sale  | 9,309                            |                      |
| Interest receivable  | 8,581                            | 8,958                |
| Other real estate owned, net   | 5,261                            | 7,048                |
| Premises and equipment, net  | 5,827                            | 5,766                |
| Deferred income taxes  | 11,532                           | 11,609               |
| Goodwill   | 3,118                            | 3,118                |
| Other assets   | 30,147                           | 26,915               |
|  | <u>          </u>                | <u>          </u>    |
| Total assets   | \$ 1,935,352                     | \$ 1,818,215         |
|  | <u>          </u>                | <u>          </u>    |
| <b>Liabilities and Shareholders Equity</b>   |                                  |                      |
| Liabilities:   |                                  |                      |
| Deposit accounts   | \$ 1,222,089                     | \$ 1,147,017         |
| Federal Home Loan Bank advances  | 298,135                          | 362,135              |
| Collateralized mortgage obligations  | 3,175                            | 15,868               |
| Accounts payable and other liabilities   | 125,846                          | 19,696               |
| Junior subordinated debentures   | 86,600                           | 86,600               |
|  | <u>          </u>                | <u>          </u>    |
| Total liabilities  | 1,735,845                        | 1,631,316            |
|  | <u>          </u>                | <u>          </u>    |
| Commitments and contingencies  |                                  |                      |
| Shareholders' equity:  |                                  |                      |
| Preferred stock, 5,000,000 shares authorized, none issued  |                                  |                      |
| Contributed capital - common stock, \$.01 par value; 20,000,000 shares authorized, 8,506,205 and 8,447,294 issued as of March 31, 2004 and December 31, 2003, respectively | 62,752                           | 61,704               |
| Retained earnings  | 179,191                          | 165,407              |
| Accumulated other comprehensive income, net  | 272                              | 155                  |
|  | <u>          </u>                | <u>          </u>    |
|  | 242,215                          | 227,266              |
| Less treasury stock, at cost 2,524,789 and 2,475,689 shares as of March 31, 2004 and December 31, 2003, respectively   | (42,708)                         | (40,367)             |
|  | <u>          </u>                | <u>          </u>    |
| Total shareholders' equity   | 199,507                          | 186,899              |
|  | <u>          </u>                | <u>          </u>    |

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|  |             |             |
|--|-------------|-------------|
| Total liabilities and shareholders' equity | \$1,935,352 | \$1,818,215 |
|--|-------------|-------------|

See accompanying notes to the unaudited consolidated financial statements.

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**ITLA CAPITAL CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF INCOME**  
(Unaudited)

|  | <b>For the Three Months Ended<br/>March 31,</b>    |               |
|--|--|---------------|
|  | <b>(in thousands except per share<br/>amounts)</b> |               |
|  | <b>2004</b>  | <b>2003</b>   |
| <b>Interest income:</b>                              |  |               |
| Loans, including fees                                | \$ 28,914  | \$ 28,614     |
| Real estate loans held in trust                      | 726  | 2,173         |
| Cash and investment securities                       | 2,443  | 2,737         |
|  | <b>32,083</b>                                      | <b>33,524</b> |
| <b>Interest expense:</b>                             |  |               |
| Deposit accounts                                     | 6,514  | 6,848         |
| Federal Home Loan Bank advances                      | 1,081  | 1,195         |
| Collateralized mortgage obligations                  | 62   | 390           |
| Junior subordinated debentures                       | 1,489  | —             |
|  | <b>9,146</b>                                       | <b>8,433</b>  |
| Net interest income before provision for loan losses | 22,937   | 25,091        |
| Provision for loan losses                            | 1,400  | 4,500         |
|  | <b>21,537</b>                                      | <b>20,591</b> |
| <b>Non-interest income:</b>                          |  |               |
| Premium on sale of loans, net                        | 9,024  | 8,718         |
| Late and collection fees                             | 101  | 67            |
| Other  | 4,269  | 3,751         |
|  | <b>13,394</b>                                      | <b>12,536</b> |
| <b>Non-interest expense:</b>                         |  |               |
| Compensation and benefits                            | 6,156  | 5,352         |
| Occupancy and equipment                              | 1,328  | 1,076         |
| Other  | 3,868  | 3,689         |
|  | <b>11,352</b>                                      | <b>10,117</b> |
| Real estate owned expense, net                       | 96   | 142           |
| Provision for losses on other real estate owned      | 1,000  | 330           |
| Gain on sale of other real estate owned, net         | (39)   | (329)         |
|  | <b>1,057</b>                                       | <b>143</b>    |
|  | <b>12,409</b>                                      | <b>10,260</b> |

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|  |                   |                   |
|--|-------------------|-------------------|
| Income before provision for income taxes and minority interest in income of subsidiary | 22,522            | 22,867            |
| Minority interest in income of subsidiary  |                   | 1,520             |
|  | <u>          </u> | <u>          </u> |
| Income before provision for income taxes   | 22,522            | 21,347            |
| Provision for income taxes   | 8,738             | 8,326             |
|  | <u>          </u> | <u>          </u> |
| NET INCOME   | \$ 13,784         | \$ 13,021         |
|  | <u>          </u> | <u>          </u> |
| BASIC EARNINGS PER SHARE   | \$ 2.21           | \$ 2.17           |
|  | <u>          </u> | <u>          </u> |
| DILUTED EARNINGS PER SHARE   | \$ 2.07           | \$ 2.02           |
|  | <u>          </u> | <u>          </u> |

See accompanying notes to the unaudited consolidated financial statements.



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**ITLA CAPITAL CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**(Unaudited)**

|   | <b>For the Three Months Ended<br/>March 31,</b> |                  |
|---|---|------------------|
|   | <b>2004</b>                                     | <b>2003</b>      |
|   | <b>(in thousands)</b>                           |                  |
| <b>Cash Flows From Operating Activities:</b>                                      |   |                  |
| Net Income  | \$ 13,784                                       | \$ 13,021        |
| Adjustments to reconcile net income to net cash provided by operating activities: |   |                  |
| Depreciation and amortization of premises and equipment                           | 477   | 388              |
| Amortization of premium on purchased loans  | 692   | 505              |
| Accretion of deferred loan origination fees, net of costs                         | (628)   | (839)            |
| Provision for loan losses   | 1,400   | 4,500            |
| Provision for losses on other real estate owned                                   | 1,000   | 330              |
| Premium on sale of RAL loans, net   | (9,024)   | (8,718)          |
| Other, net  | (25)  | 1                |
| Decrease in interest receivable   | 377   | 5                |
| Increase in other assets  | (3,298)   | (9,566)          |
| Increase in accounts payable and other liabilities                                | 106,150   | 54,011           |
|   | <b>110,905</b>                                  | <b>53,638</b>    |
| <b>Cash Flows From Investing Activities:</b>                                      |   |                  |
| Purchases of investment securities available for sale                             |   | (18,149)         |
| Proceeds from the maturity and calls of investment securities available for sale  | 3,633   | 12,941           |
| Purchase of stock in Federal Home Loan Bank                                       | (138)   | (222)            |
| Purchase of loans   |   | (1,914)          |
| Origination of RAL loans  | (12,800,573)                                    | (11,585,047)     |
| Proceeds from the participation in RAL loans                                      | 12,797,195                                      | 11,584,877       |
| (Increase) decrease in loans, net   | (14,644)  | 50,740           |
| Repayment of real estate loans held in trust                                      | 12,505  | 6,922            |
| Proceeds from sale of other real estate owned                                     | 1,738   | 4,742            |
| Other investing activities, net   | (538)   | (569)            |
|   | <b>(822)</b>                                    | <b>54,321</b>    |
| <b>Cash Flows From Financing Activities:</b>                                      |   |                  |
| Proceeds from exercise of employee stock options                                  | 1,004   | 8                |
| Cash paid to acquire treasury stock   | (2,341)   |                  |
| Principal payments on collateralized mortgage obligations                         | (12,695)  | (7,316)          |
| Increase in deposit accounts  | 75,072  | 3,603            |
| Net repayments of short-term borrowings from the Federal Home Loan Bank           | (41,000)  | (187,000)        |
| Proceeds from long-term borrowings from the Federal Home Loan Bank                | 10,000  | 16,000           |
| Repayments from long-term borrowings from the Federal Home Loan Bank              | (33,000)  | (1,700)          |
|   | <b>(2,960)</b>                                  | <b>(176,405)</b> |
| Net increase (decrease) in cash and cash equivalents                              | 107,123   | (68,446)         |
| Cash and cash equivalents at beginning of period                                  | 178,318   | 160,848          |
|   | <b>\$ 285,441</b>                               | <b>\$ 92,402</b> |
| Cash and cash equivalents at end of period  |   |                  |

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|  | <u>          </u> | <u>          </u> |
|--|-------------------|-------------------|
| Supplemental Cash Flow Information:          |                   |                   |
| Cash paid during the period for interest     | \$ 9,476          | \$ 8,028          |
| Cash paid during the period for income taxes | \$                | \$ 5,010          |
| Non-cash Investing Transactions:             |                   |                   |
| Loans transferred to other real estate owned | \$ 912            | \$ 3,012          |

See accompanying notes to the unaudited consolidated financial statements.

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**ITLA CAPITAL CORPORATION AND SUBSIDIARIES**

**NOTES TO THE UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS**

**NOTE 1 BASIS OF PRESENTATION**

The unaudited consolidated financial statements of ITLA Capital Corporation (the Company) included herein reflect all normal recurring adjustments which are, in the opinion of management, necessary to present fairly the results of operations and financial position of the Company, as of and for the interim periods indicated. The unaudited consolidated financial statements include the accounts of ITLA Capital Corporation and its wholly-owned subsidiaries, Imperial Capital Bank (the Bank), and Imperial Capital Real Estate Investment Trust (Imperial Capital REIT).

On December 31, 2003, the Company adopted FASB Interpretation No. 46 (FIN 46), Consolidation of Variable Interest Entities, which addresses consolidation by business enterprises of variable interest entities having certain characteristics. In connection with the Company's adoption of FIN 46, ITLA Capital Statutory Trust I (Trust I), ITLA Capital Statutory Trust II (Trust II), ITLA Capital Statutory Trust III (Trust III), ITLA Capital Statutory Trust IV (Trust IV), and ITLA Capital Statutory Trust V (Trust V), collectively referred to as the Trusts, were not consolidated as of December 31, 2003. The result of the deconsolidation was to recognize the Company's investment in the Trusts in other assets, and to report the amount of subordinated debentures issued by the Company to the Trusts in the liability section of the Company's consolidated balance sheet. In addition, effective January 1, 2004, the Company recognized interest expense on the subordinated debentures in the consolidated statements of income. Prior to FIN 46, the Company consolidated the Trusts and reported the trust preferred securities issued by the Trusts in the mezzanine section of the Company's consolidated balance sheets and recognized the proportionate share of income attributable to the preferred shareholders as minority interest in income of subsidiary in the consolidated statements of income. The trust preferred securities currently qualify as Tier 1 capital for ITLA Capital under Federal Reserve Board guidelines. As a result of the issuance of FIN 46, the Federal Reserve Board proposed a rule on May 6, 2004 related to the qualification of the trust preferred securities as Tier 1 capital. Under the proposed rule, the Company's trust preferred securities would still qualify as Tier 1 capital. As of March 31, 2004, the Company would meet all requirements to maintain its well capitalized designation under applicable regulatory guidelines regardless of the inclusion of the trust preferred securities in Tier 1 capital. Financial information prior to the adoption of FIN 46 has not been restated.

All intercompany transactions and balances have been eliminated. Certain information and disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States have been condensed or omitted pursuant to the rules and regulations of the U.S. Securities and Exchange Commission. Certain amounts in prior periods have been reclassified to conform to the presentation in the current period. The results of operations for the three months ended March 31, 2004 are not necessarily indicative of the results of operations for the remainder of the year.

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These unaudited consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in our annual report on Form 10-K for the year ended December 31, 2003.

**NOTE 2 ACCOUNTING FOR STOCK-BASED COMPENSATION**

The Company has stock-based compensation plans. These plans are accounted for under APB Opinion No. 25, Accounting for Stock Issued to Employees, and accordingly, no compensation costs have been recognized in the accompanying unaudited consolidated statements of income. The Company applies Statement of Financial Accounting Standards ( SFAS ) No. 123, Accounting for Stock-Based Compensation, for disclosure purposes only. SFAS No. 123 disclosures include pro forma net income and earning per share as if compensation expense had been recognized using the fair value of the options at the date of grant. If compensation had been determined based on SFAS No. 123, the Company's pro forma net income and pro forma per share data would be as follows:

|   | For the Three Months Ended<br>March 31, |           |
|---|---|-----------|
|   | 2004                                    | 2003      |
|   | (in thousands, except per share data)   |           |
| Net income, as reported   | \$ 13,784                               | \$ 13,021 |
| Less: Stock-based employee compensation expense<br>determined under the fair value method, net of tax | 337                                     | 341       |
| Pro forma net income  | \$ 13,447                               | \$ 12,680 |
| Earnings per share:   |   |           |
| Basic as reported   | \$ 2.21                                 | \$ 2.17   |
| Basic pro forma   | \$ 2.15                                 | \$ 2.11   |
| Diluted as reported   | \$ 2.07                                 | \$ 2.02   |
| Diluted pro forma   | \$ 2.02                                 | \$ 1.97   |

The fair value of each option grant was estimated on the date of grant using an option pricing model with the following weighted-average assumptions for option grants:

|                             | Weighted-Average<br>Assumptions for Option<br>Grants |             |
|-----------------------------|--|-------------|
|                             | 2004   | 2003        |
| Dividend Yield              | 0.00%  | 0.00%       |
| Expected Volatility         | 38.04%   | 31.36%      |
| Risk-Free Interest Rates    | 3.65%-4.34%  | 4.62%-4.88% |
| Expected Lives              | Seven Years  | Seven Years |
| Weighted-Average Fair Value | 12.37  | 11.36       |

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Basic Earnings Per Share ( Basic EPS ) is computed by dividing net income by the weighted-average number of common shares outstanding for the period. Diluted Earnings Per Share ( Diluted EPS ) reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock or resulted in the issuance of common stock which shared in the Company's earnings.

The following is a reconciliation of the calculation of Basic EPS and Diluted EPS:

| For the Three Months Ended March 31,  |               |   |                        |  |  |
|---------------------------------------|---------------|---|------------------------|--|--|
| (in thousands, except per share data) |               |   |                        |  |  |
|                                       | Net<br>Income | Weighted-<br>Average<br>Shares<br>Outstanding | Per<br>Share<br>Amount |  |  |
| <b>2004</b>                           |               |   |                        |  |  |
|                                       | \$ 13,784     | 6,240   | \$ 2.21                |  |  |
|                                       |               | 432   | (0.14)                 |  |  |
|                                       | \$ 13,784     | 6,672   | \$ 2.07                |  |  |
| <b>2003</b>                           |               |   |                        |  |  |
|                                       | \$ 13,021     | 6,011   | \$ 2.17                |  |  |
|                                       |               | 437   | (0.15)                 |  |  |
|                                       | \$ 13,021     | 6,448   | \$ 2.02                |  |  |

**NOTE 4 COMPREHENSIVE INCOME**

Comprehensive income, which encompasses net income and the net change in unrealized gains (losses) on investment securities available for sale, is presented below:

|  | Three Months Ended<br>March 31, |           |
|--|---------------------------------|-----------|
|  | 2004                            | 2003      |
|  | (in thousands)                  |           |
| Net Income   | \$ 13,784                       | \$ 13,021 |
| Other comprehensive income (loss):   |                                 |           |
| Change in unrealized gain (loss) on investment securities available for sale, net of tax expense (benefit) of \$75 and (\$76) for the three months ended March 31, 2004 and 2003, respectively | 117                             | (120)     |
| Comprehensive income   | \$ 13,901                       | \$ 12,901 |

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**NOTE 5 IMPAIRED LOANS RECEIVABLE**

As of March 31, 2004 and December 31, 2003, the recorded investment in impaired loans and impaired real estate loans held in trust was \$20.0 million and \$13.1 million, respectively. The average recorded investment in impaired loans was \$15.6 million for the three months ended March 31, 2004 and \$17.1 million for the same period last year. Interest income recognized on impaired loans totaled \$97,000 for the three months ended March 31, 2004 as compared to \$141,000 for the same period last year.

**NOTE 6 RESIDUAL INTEREST IN SECURITIZATION**

During the first quarter of 2002, the Company formed a limited liability company to issue \$86.3 million of asset-backed notes in a securitization of substantially all of the Company's residential loan portfolio. The Company recognized a gain of \$3.7 million on the securitization of these loans, which was included in other non-interest income within the consolidated statement of income. Concurrent with recognizing such gain on sale, the Company recorded a residual interest, which represented the present value of future cash flows (spread and fees) that are estimated to be received over the life of the loans. The residual interest is recorded on the consolidated balance sheet in Investment securities available for sale, at fair value. The value of the residual interest is subject to substantial credit, prepayment, and interest rate risk on the sold residential loans. In accordance with the provisions of SFAS No. 115, Accounting for Certain Investments in Debt and Equity Securities, the residual interest is classified as available-for-sale and, as such, recorded at fair value with the resultant changes in fair value recorded as accumulated unrealized gain or loss in a separate component of shareholders' equity entitled accumulated other comprehensive income or loss, until realized. Fair value is estimated on a monthly basis based on a discounted cash flow analysis. These cash flows are estimated over the lives of the receivables using prepayment, default, and interest rate assumptions that management believes market participants would use for similar financial instruments.

During each of the quarters ended March 31, 2004 and 2003, the Company recognized an other than temporary impairment of \$250,000 in connection with its residual interest. Impairments that are deemed to be other than temporary are charged to income as other expense. In evaluating impairments as other than temporary the Company considers credit risk, as well as the magnitude and trend of default rates and prepayment speeds of the underlying residential loans.

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At March 31, 2004 and December 31, 2003, key economic assumptions and the sensitivity of the current fair value of the residual interest based on projected cash flows to immediate adverse changes in those assumptions are as follows:

|   | <b>March 31,<br/>2004</b> | <b>December 31,<br/>2003</b> |
|---|---------------------------|------------------------------|
| <b>Dollars in thousands</b>                               |                           |                              |
| <b>Fair value of retained interest</b>                    | <b>\$5,368</b>            | <b>\$ 5,368</b>              |
| <b>Weighted average life (in years) securities</b>        | <b>0.90</b>               | <b>1.00</b>                  |
| <b>Weighted average life (in years) residual interest</b> | <b>4.05</b>               | <b>4.47</b>                  |
| <b>Weighted average annual prepayment speed</b>           | <b>35.0%</b>              | <b>35.0%</b>                 |
| Impact of 10% adverse change                              | \$ (24)                   | \$ (67)                      |
| Impact of 25% adverse change                              | \$ (67)                   | \$ (120)                     |
| <b>Weighted average annual discount rate</b>              | <b>15.0%</b>              | <b>15.0%</b>                 |
| Impact of 10% adverse change                              | \$ (284)                  | \$ (147)                     |
| Impact of 25% adverse change                              | \$ (686)                  | \$ (367)                     |
| <b>Weighted average lifetime credit losses</b>            | <b>3.3%</b>               | <b>3.3%</b>                  |
| Impact of 10% adverse change                              | \$ (147)                  | \$ (313)                     |
| Impact of 25% adverse change                              | \$ (369)                  | \$ (753)                     |

These sensitivities are hypothetical and should be used with caution. As the figures indicate, changes in the fair value of the residual interest are based on a variation in assumptions and generally cannot be extrapolated because the relationship of the change in assumption to the change in fair value may not be linear. Also, in the above table, the effect of a variation in a particular assumption on the fair value of the residual interest is calculated without changing any other assumption; in reality, changes in one factor may result in changes in another (for example, increases in market interest rates may result in lower prepayments but increased credit losses), which might magnify or counteract the sensitivities, and depending on the severity of such changes, the results of operations may be materially affected.

**NOTE 7 NEW ACCOUNTING PRONOUNCEMENTS**

On March 31, 2004, the Financial Accounting Standards Board ( FASB ) issued the Exposure Draft, Share-Based Payment, which is a proposed amendment to SFAS No. 123, Accounting For Stock-Based Compensation. In this draft, the FASB formally proposed to require companies to recognize the fair value of stock options and other stock-based compensation to employees for future reporting periods in the income statement based on their fair values. The final standard is expected in late 2004 and, as currently written, would be effective for public companies for recognition and disclosure purposes for fiscal years beginning after December 15, 2004. The Company is in the process of evaluating the impact that expensing stock options and other stock-based compensation will have on the results of operations and financial position.

**Table of Contents****NOTE 8 BUSINESS SEGMENT INFORMATION**

SFAS No. 131, Disclosures About Segments of an Enterprise and Related Information, requires disclosure of segment information in a manner consistent with the management approach. The management approach is based on the way the chief operating decision-maker organizes segments within a company for making operating decisions and assessing performance.

The main factors used to identify operating segments were the specific product and business lines of the various operating segments of the Company. Operating segments are organized separately by product and service offered. We have identified one operating segment that meets the criteria of being a reportable segment in accordance with the provisions of SFAS No. 131. This reportable segment is the origination and purchase of loans, which by its legal form, is identified as operations of the Bank and Imperial Capital REIT. This segment derives the majority of its revenue by originating and purchasing loans. Other operating segments of the Company that did not meet the criteria of being a reportable segment in accordance with SFAS No. 131 have been aggregated and reported as All Other. Substantially all of the transactions from the Company's operating segments occur in the United States.

Transactions between the reportable segment of the Company and its other operating segments are made at terms which approximate arm's-length transactions and in accordance with GAAP. There is no significant difference between the measurement of the reportable segment's assets and profits and losses disclosed below and the measurement of assets and profits and losses in our consolidated balance sheets and statements of income. Accounting allocations are made in the same manner for all operating segments.

|   | <b>Lending<br/>Operations</b> | <b>All Other</b> | <b>Eliminations</b> | <b>Consolidated</b> |
|---|-------------------------------|------------------|---------------------|---------------------|
|   | (in thousands)                |                  |                     |                     |
| <b>For the three months ended March 31,</b> |                               |                  |                     |                     |
| <b>2004</b>                                 |                               |                  |                     |                     |
| Revenues from external customers            | \$45,411                      | \$ 66            | \$                  | \$45,477            |
| Total interest income                       | 31,966                        | 314              | (197)               | 32,083              |
| Total interest expense                      | 7,681                         | 1,662            | (197)               | 9,146               |
| Net income                                  | \$15,662                      | \$13,776         | \$(15,654)          | \$13,784            |
| <b>2003</b>                                 |                               |                  |                     |                     |
| Revenues from external customers            | \$46,209                      | \$               | \$                  | \$46,209            |
| Total interest income                       | 33,626                        | 1,601            | (1,703)             | 33,524              |
| Total interest expense                      | 8,594                         | 42               | (203)               | 8,433               |
| Net income                                  | \$15,320                      | \$12,983         | \$(15,282)          | \$13,021            |



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**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

The following discussion and analysis is intended to identify the major factors that affected the financial condition and results of operations for the three months ended March 31, 2004.

**Application of Critical Accounting Policies and Accounting Estimates**

The accounting and reporting policies followed by the Company conform, in all material respects, to accounting principles generally accepted in the United States ( GAAP ) and to general practices within the financial services industry. The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. While the Company bases estimates on historical experience, current information and other factors deemed to be relevant, actual results could differ from those estimates.

The Company considers accounting estimates to be critical to reported financial results if (i) the accounting estimate requires management to make assumptions about matters that are highly uncertain and (ii) different estimates that management reasonably could have used for the accounting estimate in the current period, or changes in the accounting estimate that are reasonably likely to occur from period to period, could have a material impact on the Company's financial statements. Accounting policies related to the allowance for loan losses are considered to be critical, as these policies involve considerable subjective judgment and estimation by management. The Company also considers accounting policies related to stock-based compensation to be critical due to the continuously evolving standards, changes to which could materially impact the way the Company accounts for stock options. Additionally, the Company considers its accounting policies in regards to its tax refund lending program and other real estate owned to be critical accounting policies.

For additional information regarding critical accounting policies, refer to Note 1 Organization and Summary of Significant Accounting Policies in the Notes to Consolidated Financial Statements and the sections captioned Application of Critical Accounting Policies and Accounting Estimates and Allowance for Possible Loan Losses and Nonperforming Assets in Management's Discussion and Analysis of Financial Condition and Results of Operations included in the Company's Form 10-K for the year ended December 31, 2003. There have been no significant changes in the Company's application of accounting policies since December 31, 2003.

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**RESULTS OF OPERATIONS**

**Three Months Ended March 31, 2004 Compared to Three Months Ended March 31, 2003**

**Executive Summary**

Consolidated net income was \$13.8 million and \$13.0 million for the three months ended March 31, 2004 and 2003, respectively. Diluted EPS was \$2.07 for the three months ended March 31, 2004 compared to \$2.02 for the same period last year, an increase of \$0.05 per diluted share. The increase in net income was primarily due to increases in net interest income after provision for loan losses and non-interest income, partially offset by an increase in non-interest expense.

Net interest income before provision for loan losses decreased from the prior year period primarily as a result of the increase in interest expense, which, pursuant to the adoption of FIN 46, included for the first time the interest payments on the junior subordinated debentures, and the decrease in net interest income earned by the REIT. The return on average assets was 2.11% for the three months ended March 31, 2004 compared to 1.81% for the same period last year. The return on average shareholders' equity was 28.17% for the three months ended March 31, 2004, compared to 31.72% for the same period last year.

Total loan production was \$155.1 million for the quarter ended March 31, 2004 compared to \$101.7 million for the same period last year. Loan production during the current quarter consisted of originations of \$118.3 million of commercial real estate loans, \$20.4 million of film finance loans and \$16.4 million of franchise loans. Loan production for the same period last year consisted of originations of \$84.5 million of commercial real estate loans, \$15.3 million of film finance loans and \$1.8 million of franchise loans.

The increase in non-interest income was primarily due to income earned in connection with the Bank's refund anticipation loan (RAL) program and its strategic relationship with Household International, Inc. (Household). Substantially all RAL loans originated during the quarter were sold to Household. At March 31, 2004, the Company held \$3.1 million in RAL participation interests and \$9.3 million of RAL loans held for sale. Because the origination of loans under the RAL program results from the filing of individual income tax returns, transaction activity is concentrated most heavily during the tax season. This results in the Company earning most of its RAL program income in the first quarter of the year. We expect that our financial results for the remaining quarters of 2004 will not be significantly impacted by the RAL program due to the seasonal nature of the business.

**Table of Contents****Net Interest Income and Margin**

The following table presents, for the three months ended March 31, 2004 and 2003, our condensed average balance sheet information, together with interest income and yields earned on average interest-earning assets and interest expense and rates paid on average interest-bearing liabilities. Average balances are computed using daily average balances. Nonaccrual loans are included in loans receivable.

**For the Three Months Ended March 31,**

|   | 2004            |                |            | 2003            |                |            |
|---|-----------------|----------------|------------|-----------------|----------------|------------|
|   | Average Balance | Income/Expense | Yield/Rate | Average Balance | Income/Expense | Yield/Rate |
| (dollars in thousands)  |                 |                |            |                 |                |            |
| <b>Assets</b>   |                 |                |            |                 |                |            |
| Cash and investments  | \$ 909,613      | \$ 2,443       | 1.08%      | \$ 726,718      | \$ 2,737       | 1.53%      |
| Loans receivable:   |                 |                |            |                 |                |            |
| Loans   | 1,477,207       | 28,914         | 7.87%      | 1,343,338       | 28,614         | 8.64%      |
| Real estate loans held in trust   | 62,168          | 726            | 4.70%      | 121,008         | 2,173          | 7.28%      |
| Total loans receivable  | 1,539,375       | 29,640         | 7.74%      | 1,464,346       | 30,787         | 8.53%      |
| Total interest-earning assets   | 2,448,988       | \$32,083       | 5.27%      | 2,191,064       | \$33,524       | 6.21%      |
| Non-interest-earning assets   | 217,822         |                |            | 85,410          |                |            |
| Allowance for loan losses   | (34,165)        |                |            | (34,139)        |                |            |
| Total assets  | \$2,632,645     |                |            | \$2,242,335     |                |            |
| <b>Liabilities and Shareholders' Equity</b>   |                 |                |            |                 |                |            |
| Deposit accounts:   |                 |                |            |                 |                |            |
| Savings and passbook accounts   | \$ 145,462      | \$ 598         | 1.65%      | \$ 152,739      | \$ 454         | 1.21%      |
| Demand accounts   | 65,706          | 247            | 1.51%      | 6,632           | 17             | 1.04%      |
| Time certificates   | 980,761         | 5,669          | 2.32%      | 870,801         | 6,377          | 2.97%      |
| Total deposit accounts  | 1,191,929       | 6,514          | 2.20%      | 1,030,172       | 6,848          | 2.70%      |
| Collateralized mortgage obligations   | 9,662           | 62             | 2.58%      | 59,899          | 390            | 2.64%      |
| FHLB advances and other borrowings  | 147,679         | 1,081          | 2.94%      | 166,625         | 1,195          | 2.91%      |
| Junior subordinated debentures  | 86,600          | 1,489          | 6.92%      |                 |                |            |
| Total interest-bearing liabilities  | 1,435,870       | \$ 9,146       | 2.56%      | 1,256,696       | \$ 8,433       | 2.72%      |
| Non-interest-bearing liabilities  | 999,992         |                |            | 737,545         |                |            |
| Guaranteed preferred beneficial interests in the Company's junior subordinated deferrable interest debentures |                 |                |            | 81,625          |                |            |
| Shareholders' equity  | 196,783         |                |            | 166,469         |                |            |
| Total liabilities and shareholders' equity  | \$2,632,645     |                |            | \$2,242,335     |                |            |
| Net interest spread   |                 |                | 2.71%      |                 |                | 3.49%      |
| Net interest income before provision for loan losses  |                 | \$22,937       |            |                 | \$25,091       |            |

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|                     |       |       |       |       |
|---------------------|-------|-------|-------|-------|
| Net interest margin | <hr/> | 3.77% | <hr/> | 4.64% |
|---------------------|-------|-------|-------|-------|

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The following table sets forth a summary of the changes in interest income and interest expense resulting from changes in average interest-earning asset and interest-bearing liability balances and changes in average interest rates. The change in interest due to both volume and rate has been allocated to change due to volume and rate in proportion to the relationship of absolute dollar amounts of each.

|   | <b>For the Three Months Ended<br/>March 31, 2004 and 2003<br/>Increase (Decrease) Due to:</b> |                   |                   |
|---|---|-------------------|-------------------|
|   | <b>Rate</b>   | <b>Volume</b>     | <b>Total</b>      |
|   | (In thousands)  |                   |                   |
| <b>Interest and fees earned from:</b>         |   |                   |                   |
| Cash and investment securities                | \$ (796)  | \$ 502            | \$ (294)          |
| Loans   | (1,963)   | 2,263             | 300               |
| Real estate loans held in trust               | (767)   | (680)             | (1,447)           |
|   | <u>          </u>   | <u>          </u> | <u>          </u> |
| Total increase (decrease) in interest income  | (3,526)   | 2,085             | (1,441)           |
|   | <u>          </u>   | <u>          </u> | <u>          </u> |
| <b>Interest paid on:</b>                      |   |                   |                   |
| Deposit accounts                              | (1,244)   | 910               | (334)             |
| Collateralized mortgage obligations           | (9)   | (319)             | (328)             |
| FHLB advances                                 | 13  | (127)             | (114)             |
| Junior subordinated debentures                | <u>          </u>   | 1,489             | 1,489             |
|   | <u>          </u>   | <u>          </u> | <u>          </u> |
| Total increase (decrease) in interest expense | (1,240)   | 1,953             | 713               |
|   | <u>          </u>   | <u>          </u> | <u>          </u> |
| Increase (decrease) in net interest income    | \$ (2,286)  | \$ 132            | \$ (2,154)        |
|   | <u>          </u>   | <u>          </u> | <u>          </u> |

Total interest income decreased \$1.4 million to \$32.1 million in the first quarter of 2004 as compared to \$33.5 million for the same period last year. The net decrease in interest income was primarily attributable to the decrease of 94 basis points in the yields earned on interest earning assets, partially offset by an increase of \$257.9 million in interest earning assets.

The average balance of loans held by the Bank was \$1.5 billion and \$1.3 billion for the three months ended March 31, 2004 and 2003, respectively. Loans secured by income producing properties and construction loans had an average balance of \$1.3 billion during the quarter ended March 31, 2004 compared to \$1.2 billion during the same period last year. The average balance of franchise loans was \$105.6 million and \$56.7 million during the quarters ended March 31, 2004 and 2003, respectively. The average balance of film finance loans was \$97.6 million and \$115.0 million during the quarters ended March 31, 2004 and 2003, respectively.

The average balance of real estate loans held in trust decreased to \$62.2 million for the three months ended March 31, 2004 as compared to \$121.0 million for the same period last year. This decrease was due to loan prepayments and principal amortization.

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The average balance of cash and investments increased to \$909.6 million in the first quarter of 2004 compared to \$726.7 million during the same period last year. The increase in average cash and investments was attributable to the increased liquidity that was maintained in connection with the Bank's RAL program, as well as the timing of the funding and corresponding settlement of RAL production at March 31, 2004. The decline in the average yield earned on cash and investments from 1.53% during the first quarter of 2003 to 1.08% during the first quarter of 2004 was primarily caused by lower yields earned on short-term and overnight investments.

The average yield earned on total loans decreased to 7.74% in the quarter ended March 31, 2004 as compared to 8.53% in the same period last year. The decline in our yield was primarily caused by higher yielding loans being repaid and replaced by new loan production at lower current market interest rates. Our commercial real estate loan portfolio is primarily comprised of adjustable rate mortgages indexed to six month LIBOR. Approximately 95.5% of our real estate loans (including real estate loans held in trust) were adjustable rate mortgages at March 31, 2004. These adjustable rate mortgages generally reprice on a quarterly basis. At March 31, 2004, approximately \$1.2 billion or 91.7% of our real estate loans contained interest rate floors, below which the loans' contractual interest rate may not adjust. At March 31, 2004, the weighted average floor interest rate of these loans was 5.6%. At that date, approximately \$1.1 billion or 95.4% of those loans were at the floor interest rate, approximately \$56.5 million or 4.5% were within 50 basis points of their floor interest rate, and approximately \$0.5 million or 0.1% were greater than 50 but less than 100 basis points from their floor interest rate.

Total interest expense increased by \$0.7 million to \$9.1 million in the first quarter of 2004, compared to \$8.4 million for the same period last year. This increase was attributable to the adoption of FIN 46, which required that beginning January 1, 2004, the Company recognize interest expense incurred on its junior subordinated debentures issued to the Trusts in the consolidated statements of income. For the three months ended March 31, 2004, the junior subordinated debentures had an average balance of \$86.6 million and an average cost of 6.92%.

Excluding the impact of the adoption of FIN 46, interest expense decreased by \$0.8 million. This decrease was caused by lower interest rates paid on all interest bearing liabilities and lower average balances on our Collateralized Mortgage Obligations ( CMOs ) and Federal Home Loan Bank ( FHLB ) advances partially offset by higher average balances on deposit accounts.

Our average cost of funds decreased to 2.56% during the three month period ended March 31, 2004, compared to 2.72% for the same period last year. This decrease in funding costs was due primarily to lower rates being paid on our deposit accounts as compared to the same period last year as a result of the general decline in market interest rates. The average rate paid on deposit accounts was 2.20% during the three months ended March 31, 2004 as compared to 2.70% for the same period last year. The average rate paid on the CMOs was 2.58% during the three months ended March 31, 2004 compared to 2.64% for the same period last year. The average balance of deposit accounts increased \$161.8 million to \$1.2 billion for the three months ended March 31, 2004 as compared to \$1.0 billion for the same period last year. The average balance of our CMOs was \$9.7 million during the first quarter of 2004, compared to \$59.9

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million for the same period last year reflecting the decline in the related real estate loans held in trust. FHLB advances averaged \$147.7 million in the current quarter, compared to \$166.6 million for the same period last year.

Net interest margin decreased to 3.77% for the three months ended March 31, 2004 as compared to 4.64% for the same period last year primarily due to the adoption of FIN 46 and to higher yielding loans within the Bank's loan portfolio being repaid and replaced by new loan production at lower current market rates.

**Provision for Loan Losses**

Management periodically assesses the adequacy of the allowance for loan losses by reference to many factors, which may be weighted differently at various times depending on prevailing conditions. These factors include, among other elements:

general portfolio trends relative to asset and portfolio size;

asset categories;

credit and geographic concentrations;

delinquency trends and nonaccrual loan levels;

historical loss experience; and

risks associated with changes in economic, social and business conditions.

Accordingly, the calculation of the adequacy of the allowance for loan losses is not based solely on the level of nonperforming assets. Management believes that the allowance for loan losses as of March 31, 2004 was adequate to absorb the known and inherent risks of loss in the loan portfolio at that date. While management believes the estimates and assumptions used in its determination of the adequacy of the allowance are reasonable, there can be no assurance that such estimates and assumptions will not be proven incorrect in the future, or that the actual amount of future provisions will not exceed the amount of past provisions or that any increased provisions that may be required will not adversely impact our financial condition and results of operations. In addition, the determination of the amount of the Bank's allowance for loan losses is subject to review by the Bank's regulators, as part of the routine examination process, which may result in the establishment of additional reserves based upon their judgment of information available to them at the time of their examination.

The consolidated provision for loan losses totaled \$1.4 million for the first quarter of 2004, compared to \$4.5 million for the same period last year. The current period provision for loan losses was recorded to provide for reserves adequate to absorb known and inherent risks of losses in the loan portfolio. Our assessment of the provision for loan losses includes evaluation of certain nonperforming loans and other loans of concern. The prior year provision included specific reserves related to certain nonperforming loans and other loans of concern. The allowance for loan losses was 2.26% of total loans and real estate loans held in trust at March 31, 2004 as compared to 2.17% at December 31, 2003. During the quarter ended March 31, 2004, we had net loan recoveries of \$84,000 as compared to net loan charge-offs of \$5.0 million during the same period last year. See also [Financial Condition](#) [Credit Risk](#) .

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### **Non-Interest Income**

Non-interest income increased to \$13.4 million for the three months ended March 31, 2004, compared to \$12.5 million for the same period last year. Substantially all of the increase was due to income earned in connection with the RAL program, consisting of \$9.0 million of net premiums earned on the sale of RAL loans and \$4.2 million of processing and administrative fees. During the same period last year, amounts earned related to the RAL program were \$8.7 million and \$3.6 million, respectively.

### **Non-Interest Expense**

Non-interest expense totaled \$12.4 million for the three months ended March 31, 2004, compared to \$10.3 million for the same period last year. The increase was caused by our expansion of Imperial Capital Express ( ICE ), the Bank's small balance commercial real estate lending platform, and certain infrastructure and personnel costs related to the Bank's charter conversion. Additionally, non-interest expense increased due to a \$1.0 million charge-off of an other real estate owned property. The charge-off was recorded to reflect a decline in the estimated fair value of the property that was identified during the period. Our efficiency ratio (defined as recurring general and administrative expenses as a percentage of net revenue) was 31.2 percent in the first quarter of 2004 as compared to 26.9 percent for the same period in 2003.

## **FINANCIAL CONDITION**

Total assets increased to \$1.9 billion at March 31, 2004 as compared to \$1.8 billion at December 31, 2003. At March 31, 2004, loans, net totaled \$1.5 billion, including approximately \$1.3 billion of commercial real estate loans, \$115.7 million of franchise loans and \$94.1 million of film finance loans. During the three months ended March 31, 2004, the Bank's loan portfolio increased \$15.8 million and the REIT's portfolio decreased \$13.0 million. The decrease in the REIT's loan portfolio reflects the continued loan prepayments experienced during the three months ended March 31, 2004. Additionally, cash and cash equivalents increased \$107.1 million primarily as a result of increased liquidity caused by the timing of the funding and corresponding settlement of RAL production at March 31, 2004. Loans held for sale consist of the RAL loans funded by the Bank on March 31, 2004 that were subsequently sold the following day to Household. Total deposit accounts increased to \$1.2 billion at March 31, 2004 from \$1.1 billion at December 31, 2003. FHLB advances decreased \$64.0 million to \$298.1 million at March 31, 2004, compared to \$362.1 million at December 31, 2003. Management believes that a significant portion of deposits will remain with us upon maturity based on our historical experience regarding retention of deposits. CMOs decreased \$12.7 million to \$3.2 million at March 31, 2004 compared to \$15.9 million at December 31, 2003 reflecting the decline in real estate loans held in trust. Accounts payable and other liabilities increased \$106.2 million primarily as a result of outstanding checks and other liabilities related to the RAL program.

### **Residual Interest**

In the first quarter of 2002, we formed a limited liability company to issue \$86.3 million of asset-backed notes in a securitization of substantially all of our residential loan portfolio. These notes were rated AAA by Standard & Poor's, Aaa by Moody's, and are insured by Financial Security Assurance. In the securitization, residential loans were sold to the limited



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liability company for a cash purchase price and an interest in the loans securitized in the form of the excess spread. The cash purchase price was raised through an offering of asset-backed notes issued by the limited liability company. Note holders are entitled to receive the principal collected on the loans and the stated interest rate on the notes. We are entitled to receive the excess spread. The excess spread generally represents, over the estimated life of the loans, the excess of the weighted average coupon on the loans sold over the sum of the note interest rate less other expenses including a trustee fee and an insurance fee. Valuation of the excess spread includes an estimate of annual future credit losses related to the loans securitized. These estimated cash flows are discounted when computing the value of the residual interest.

We recognized a gain on the sale of these loans, although cash (representing the excess spread and servicing fees) is received by us over the lives of the loans. Concurrent with recognizing such gain on sale, we recorded the excess spread as a residual interest, which is included in our consolidated balance sheets as Investment securities available for sale, at fair value. The value of the residual interest is subject to substantial credit, prepayment and interest rate risk on the sold residential loans.

In accordance with the provisions of SFAS No. 115, Accounting for Certain Investments in Debt and Equity Securities, we classified our residual interest as an available-for-sale asset and, as such, they are recorded at fair value with the resultant changes in fair value recorded as accumulated unrealized gain or loss in a separate component of shareholders equity entitled accumulated other comprehensive income or loss, until realized. We estimate fair value on a monthly basis based on a discounted cash flow analysis. These cash flows are estimated over the lives of the receivables using prepayment, default, and interest rate assumptions that we believe market participants would use for similar financial instruments.

During each of the three months ended March 31, 2004 and 2003, we recognized an other than temporary impairment of \$250,000 in connection with our residual interest. Impairments that are deemed to be other than temporary are charged to income, as other expense. In evaluating impairments as other than temporary we consider credit risk, as well as the magnitude and trend of default rates and prepayment speeds of the underlying residential loans.

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At March 31, 2004 and December 31, 2003, key economic assumptions and the sensitivity of the current fair value of the residual interest based on projected cash flows to immediate adverse changes in those assumptions is as follows:

|   | <b>March 31,<br/>2004</b> | <b>December 31,<br/>2003</b> |
|---|---------------------------|------------------------------|
| <b>Dollars in thousands</b>                               |                           |                              |
| <b>Fair value of retained interest</b>                    | <b>\$5,368</b>            | <b>\$ 5,368</b>              |
| <b>Weighted average life (in years) securities</b>        | <b>0.90</b>               | <b>1.00</b>                  |
| <b>Weighted average life (in years) residual interest</b> | <b>4.05</b>               | <b>4.47</b>                  |
| <b>Weighted average annual prepayment speed</b>           | <b>35.0%</b>              | <b>35.0%</b>                 |
| Impact of 10% adverse change                              | \$ (24)                   | \$ (67)                      |
| Impact of 25% adverse change                              | \$ (67)                   | \$ (120)                     |
| <b>Weighted average annual discount rate</b>              | <b>15.0%</b>              | <b>15.0%</b>                 |
| Impact of 10% adverse change                              | \$ (284)                  | \$ (147)                     |
| Impact of 25% adverse change                              | \$ (686)                  | \$ (367)                     |
| <b>Weighted average lifetime credit losses</b>            | <b>3.3%</b>               | <b>3.3%</b>                  |
| Impact of 10% adverse change                              | \$ (147)                  | \$ (313)                     |
| Impact of 25% adverse change                              | \$ (369)                  | \$ (753)                     |

These sensitivities are hypothetical and should be used with caution. As the figures indicate, changes in the fair value of our residual are based on a variation in assumptions and generally cannot be extrapolated because the relationship of the change in assumption to the change in fair value may not be linear. Also, in the above table, the effect of a variation in a particular assumption on the fair value of the residual interest is calculated without changing any other assumption; in reality, changes in one factor may result in changes in another (for example, increases in market interest rates may result in lower prepayments but increased credit losses), which might magnify or counteract the sensitivities, and depending on the severity of such changes, the results of operations may be materially affected.

**Table of Contents****CREDIT RISK****Nonperforming Assets, Other Loans of Concern and Allowance for Loan Losses**

The following table sets forth our nonperforming assets by category and troubled debt restructurings as of the dates indicated.

|   | <b>March 31,<br/>2004</b>     | <b>December 31,<br/>2003</b> |
|---|-------------------------------|------------------------------|
|   | <b>(dollars in thousands)</b> |                              |
| Nonaccrual loans:   |                               |                              |
| Real estate   | \$ 5,213                      | \$ 4,686                     |
| Franchise   | 4,008                         | 799                          |
| Film finance  | 6,537                         | 3,030                        |
|   | <u>          </u>             | <u>          </u>            |
| Total nonaccrual loans  | 15,758                        | 8,515                        |
| Other real estate owned, net  | 5,261                         | 7,048                        |
|   | <u>          </u>             | <u>          </u>            |
| Total nonperforming assets  | 21,019                        | 15,563                       |
| Performing troubled debt restructurings                             | 1,978                         | 4,709                        |
|   | <u>          </u>             | <u>          </u>            |
|   | <u>\$ 22,997</u>              | <u>\$ 20,272</u>             |
|   | <u>          </u>             | <u>          </u>            |
| Nonaccrual loans to total loans and real estate loans held in trust | 1.02%                         | 0.55%                        |
| Allowance for loan losses to nonaccrual loans                       | 221.38%                       | 392.26%                      |
| Nonperforming assets to total assets                                | 1.09%                         | 0.86%                        |

At March 31, 2004, other real estate owned consisted of three properties totaling \$5.3 million. Management periodically evaluates the estimated fair value of its other real estate owned properties. During the quarter ended March 31, 2004, we recorded a \$1.0 million charge-off to write-down the value of other real estate owned. Subsequent to the quarter ended March 31, 2004, the Bank sold one of these other real estate owned properties in April 2004 and the remaining two properties are in escrow and are expected to close during the second quarter of 2004.

As of March 31, 2004 and December 31, 2003, other loans of concern totaled \$24.5 million and \$31.3 million, respectively. Other loans of concern consist of loans with respect to which known information concerning possible credit problems with the borrowers or the cash flows of the properties securing the respective loans has caused management to be concerned about the ability of the borrowers to comply with present loan repayment terms, which may result in the future inclusion of such loans in the nonaccrual category. The decrease in other loans of concern for the three months ended March 31, 2004 was primarily due to \$3.9 million of loans being paid-off, \$5.3 million of loans migrating to nonaccrual status, \$1.7 million of loans being upgraded and \$880,000 of loans being transferred to other real estate owned, partially offset by \$5.0 million of new other loans of concern.

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The following table provides certain information with respect to our allowance for loan losses, including charge-offs, recoveries and selected ratios for the periods indicated.

|   | <b>For the Three<br/>Months Ended<br/>March 31,<br/>2004</b> | <b>For the Year<br/>Ended<br/>December 31,<br/>2003</b> |
|---|--|---|
|   | (dollars in thousands)                                       |   |
| Balance at beginning of period  | \$ 33,401  | \$ 33,009   |
| Provision for loan losses   | 1,400  | 7,760   |
| Charge-offs   |  | (7,447)   |
| Recoveries  | 84   | 79  |
|   | <u>84</u>  | <u>79</u>   |
| Net recoveries (charge-offs)  | 84   | (7,368)   |
|   | <u>84</u>  | <u>(7,368)</u>  |
| Balance at end of period  | <u>\$ 34,885</u>   | <u>\$ 33,401</u>  |
| Allowance for loan losses as a percentage of loans and loans held in trust, net | 2.26%  | 2.17%   |

**Liquidity**

Liquidity refers to our ability to maintain cash flow adequate to fund operations and meet obligations and other commitments on a timely basis, including the payment of maturing deposits and the origination or purchase of new loans. We maintain a cash and investment securities portfolio designed to satisfy operating liquidity requirements while preserving capital and maximizing yield. As of March 31, 2004, we held \$285.4 million of cash and cash equivalents (consisting primarily of short-term investments with original maturities of 90 days or less) and \$49.6 million of investment securities classified as available for sale.

Short-term fixed income investments classified as cash equivalents consisted of interest-bearing deposits at financial institutions, government money market funds and short-term government agency securities, while investment securities available for sale consisted primarily of fixed income instruments, which were rated AAA, or equivalent by nationally recognized rating agencies. In addition, our liquidity position is supported by a credit facility with the Federal Home Loan Bank of San Francisco. As of March 31, 2004, we had remaining available borrowing capacity under this credit facility of \$284.4 million, net of the \$15.0 million of additional Federal Home Loan Bank stock that we would be required to purchase to support those additional borrowings, \$30.0 million of unused federal funds credit facilities under established lines of credit with two banks, and a \$25.0 million revolving credit facility with a bank.

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**Capital Resources**

The Company, the Bank's holding company, had Tier 1 leverage, Tier 1 risk based and total risk-based capital ratios at March 31, 2004 of 10.0%, 16.4% and 18.8%, respectively, which represents \$130.3 million, \$165.8 million and \$138.2 million, respectively, of capital in excess of the amount required to be well capitalized for bank holding company regulatory purposes. These ratios were 14.2%, 15.6% and 18.2% as of December 31, 2003, respectively.

The Bank had Tier 1 leverage, Tier 1 risk based and total risk-based capital ratios at March 31, 2004 of 8.9%, 14.8% and 16.0%, respectively, which represents \$100.2 million, \$135.3 million and \$92.9 million, respectively, of capital in excess of the amount required to be well capitalized for regulatory purposes. These ratios were 13.2%, 14.3% and 15.6% as of December 31, 2003, respectively.

At March 31, 2004, shareholders' equity totaled \$199.5 million, or 10.3 percent of total assets. Our book value per share of common stock was \$33.35 as of March 31, 2004, as compared to \$31.30 as of December 31, 2003, and \$29.37 as of March 31, 2003.

**Item 3. Quantitative and Qualitative Disclosures About Market Risk**

Our estimated sensitivity to interest rate risk, as measured by the estimated interest earnings sensitivity profile and the interest sensitivity gap analysis, has not materially changed from the information disclosed in our annual report on Form 10-K for the year ended December 31, 2003.

**Item 4. Controls and Procedures**

(a) Evaluation of Disclosure Controls and Procedures: An evaluation of the Company's disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934 (the "Act")) was carried out as of March 31, 2004 under the supervision and with the participation of the Company's Chief Executive Officer, Chief Financial Officer and several other members of the Company's senior management. The Company's Chief Executive Officer and Chief Financial Officer concluded that, as of March 31, 2004, the Company's disclosure controls and procedures are effective in ensuring that the information required to be disclosed by the Company in the reports it files or submits under the Act is (i) accumulated and communicated to the Company's management (including the Chief Executive Officer and Chief Financial Officer) in a timely manner, and (ii) recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms.

(b) Changes in Internal Control over Financial Reporting: During the quarter ended March 31, 2004, no change occurred in the Company's internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

**Table of Contents****PART II OTHER INFORMATION****Item 1. Legal Proceedings**

We are party to certain legal proceedings incidental to our business. Management believes that the outcome of such proceedings, in the aggregate, will not have a material effect on our financial condition or results of operations.

**Item 2. Changes in Securities, Use of Proceeds and Issuer Repurchases of Equity Securities**

The following table sets forth the repurchases of our common stock for the fiscal quarter ended March 31, 2004.

| Period                                   | Total Number of<br>Shares Purchased | Average Price<br>Paid<br>per Share | Total Number of<br>Shares Purchased<br>as<br>Part of Publicly<br>Announced Plans<br>or<br>Programs | Maximum Number of<br>Shares that May Yet<br>Be Purchased Under<br>the Plans or<br>Programs |
|--|-------------------------------------|------------------------------------|--|--|
| January 1, 2004 to<br>January 31, 2004   | 7,000                               | \$49.55                            | 7,000  | 175,876  |
| February 1, 2004 to<br>February 29, 2004 | 18,700                              | 48.11                              | 18,700   | 157,176  |
| March 1, 2004 to<br>March 31, 2004       | 23,400                              | 46.76                              | 23,400   | 133,776  |
| Total                                    | 49,100                              | \$47.70                            | 49,100   | 133,776  |

These repurchases were made under a program announced on December 21, 2001 for the repurchase of up to 5% of the outstanding shares.

**Item 3. Defaults Upon Senior Securities**

Not applicable.

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

None.

**Item 5. Other Information**

None.

**Item 6. Exhibits and Reports on Form 8-K**

(a) See exhibit index

(b) During the first quarter of 2004, we filed or furnished the following reports on Form 8-K:

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| Item # | Item Description  | Filing Date       |
|--------|---|-------------------|
| 12     | Earnings Press Release for the year ended December 31, 2003 | February 11, 2004 |
| 9      | Materials Presented at an Industry Conference               | February 18, 2004 |

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**SIGNATURES**

Pursuant to the requirements 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.

**ITLA CAPITAL CORPORATION**

Date: May 10, 2004

/s/ George W. Haligowski

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George W. Haligowski  
Chairman of the Board, President and  
Chief Executive Officer

Date: May 10, 2004

/s/ Timothy M. Doyle

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Timothy M. Doyle  
Senior Managing Director and  
Chief Financial Officer



**Table of Contents****EXHIBIT INDEX**

| Regulation S-K<br>Exhibit Number | Document   | Reference to Prior<br>Filing or Exhibit<br>Number Attached<br>Hereto |
|----------------------------------|--|--|
| 3.1                              | Certificate of Incorporation   | **   |
| 3.2                              | Bylaws, as amended   | *****  |
| 4                                | Instruments Defining the Rights of Security Holders, Including Indentures  | None   |
| 10.1                             | 1995 Stock Option Plan For Nonemployee Directors   | *  |
| 10.2                             | 1995 Employee Stock Incentive Plan   | *****  |
| 10.3a                            | Nonqualified (Non-Employer Securities) Deferred Compensation Plan  | *****  |
| 10.3b                            | Nonqualified (Employer Securities Only) Deferred Compensation Plan   | *****  |
| 10.4                             | Supplemental Salary Savings Plan   | *  |
| 10.5                             | Data Processing Agreement  | *  |
| 10.6                             | Employment Agreement with George W. Haligowski   | *  |
| 10.7                             | Change of Control Agreements   | ***  |
| 10.8                             | Recognition and Retention Plan   | **   |
| 10.9                             | Voluntary Retainer Stock and Deferred Compensation Plan for Outside Directors  | **   |
| 10.10                            | Supplemental Executive Retirement Plan   | *****  |
| 10.11                            | ITLA Capital Corporation Rabbi Trust Agreement   | ***  |
| 10.12                            | Salary Continuation Plan   | ***  |
| 10.13                            | Licensing Agreement, dated October 30, 2002, between Imperial Capital Bank and Beneficial Franchise Company, Inc.  | *****  |
| 10.14                            | Amended and Restated Sale and Servicing Agreement for RALs and RACs, dated as of January 3, 2003, between Imperial Capital Bank, Household Tax Masters Inc., and Household Tax Masters Acquisition Corporation | *****  |
| 11                               | Statement Regarding Computation of Per Share Earnings  | None   |
| 13                               | Quarterly Report to Security Holders   | None   |
| 15                               | Letter Regarding Unaudited Interim Financial Information   | None   |
| 18                               | Letter Regarding Change in Accounting Principles   | None   |
| 19                               | Report furnished to Security Holders   | None   |
| 22                               | Published Report Regarding Matters Submitted to Vote of Security Holders   | None   |
| 23                               | Consent of Experts   | None   |
| 24                               | Power of Attorney  | None   |
| 31.1                             | Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer  | 31.1   |
| 31.2                             | Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer  | 31.2   |
| 32                               | Section 1350 Certifications of Chief Executive Officer and Chief Financial Officer   | 32   |

\* Filed as an exhibit to Imperial's Registration Statement on Form S-1 (File No. 33-96518) filed with the Commission on September 1, 1995, pursuant to Section 5 of the Securities Act of 1933.

\*\* Filed as an exhibit to the Company's Registration Statement on Form S-4 (File No. 333-03551) filed with the Commission on May 10, 1996, pursuant to Section 5 of the Securities Act of 1933.\*\*\* Filed as an exhibit to

the Company's  
Form 10-K for  
the year ended  
December 31,  
1999 (File  
No. 0-26960).\*\*\*\* Filed  
as an exhibit to  
the Company's  
Registrant's  
Form 10-K for  
the year ended  
December 31,  
2000 (File  
No. 0-26960).\*\*\*\*\* Filed  
as an exhibit to  
the Company's  
Quarterly  
Report on  
Form 10-Q for  
the quarter  
ended  
September 30,  
2000 (File  
No. 0-26960).\*\*\*\*\* Filed  
as an appendix  
to the  
Company's  
definitive proxy  
materials filed  
on  
September 29,  
2001.\*\*\*\*\* Filed  
as an exhibit to  
the Current  
Report on  
Form 8-K filed  
by the Company  
on February 5,  
2003 (File  
No. 0-26960).  
Portions of this  
exhibit have  
been omitted  
pursuant to a  
request for  
confidential  
treatment  
granted by the  
Commission.\*\*\*\*\* Filed  
as an exhibit to  
the Company's  
Quarterly  
Report on  
Form 10-Q for  
the quarter  
ended  
September 30,  
2003 (File  
No. 0-26960).