

PUBLIC DISCLOSURE

March 3, 2003

COMMUNITY REINVESTMENT ACT PERFORMANCE EVALUATION

**First State Bank
RSSD #2685764**

**822 North Humphreys Street
Flagstaff, Arizona 86001**

**Federal Reserve Bank of San Francisco
101 Market Street
San Francisco, California 94105**

NOTE: This document is an evaluation of this institution's record of meeting the credit needs of its entire community, including low- and moderate-income neighborhoods, consistent with safe and sound operation of the institution. This evaluation is not, nor should it be construed as, an assessment of the financial condition of this institution. The rating assigned to this institution does not represent an analysis, conclusion or opinion of the federal financial supervisory agency concerning the safety and soundness of this financial institution.

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INSTITUTION

INSTITUTION'S CRA RATING: This institution is rated satisfactory.

First State Bank demonstrates an overall satisfactory level of performance under the Community Reinvestment Act, as measured by the small bank performance criteria. The loan-to-deposit ratio was reasonable and a majority of loan originations were inside the assessment area. The bank demonstrated excellent performance in reaching businesses of different sizes. The overall dispersion of lending by census tract was reasonable, with no conspicuous gaps in the lending patterns.

PERFORMANCE CONTEXT

Description of Institution

First State Bank (FSB) is a relatively new community bank headquartered in Flagstaff, Arizona. Opened in September 1998, FSB is a wholly-owned subsidiary of Arizona Bancshares, Inc., a parent company that engages in no other activity outside of owning FSB. FSB operates two branch offices in Flagstaff, Arizona, one of which was opened within the past three years. After its original opening in July 2000, the branch relocated to its current location in downtown Flagstaff on October 10, 2000. The new branch was authorized for full service but FSB operates it as a loan and operation center. The branch can accept non-cash deposits but does not maintain cash on the premises.

As of September 30, 2002, total assets equaled \$33 million, of which approximately \$24 million were loans. Strategically, the bank seeks to serve the credit needs of small businesses throughout the city of Flagstaff. FSB offers consumer loan products on an accommodation basis, which include residential construction loans, home-equity and overdraft lines of credit, conforming residential real estate loans, and consumer installment loans. However, the bank's target lending is commercial, with an emphasis on small- and medium-sized businesses. Target businesses include real estate developers who are also offered residential construction loans. The strategic focus is reflected in the diversity of the portfolio mix, as reported in the September 30, 2002, Consolidated Report of Condition depicted below.

Loan Type	Dollar Amount ('000s)	% of Loan Portfolio
Commercial/Industrial & Nonfarm, Nonresidential Real Estate	\$10,967	46%
Construction	\$9,020	37%
Secured by 1-4 Family Residential Real Estate	\$2,692	11%
Consumer and Other	\$1,386	6%
Total Loans	\$24,065	100%

There are no legal or financial impediments that would prevent the bank from helping to meet the credit needs of its assessment area consistent with its business strategy, size, financial capacity and local economic conditions. The bank received a satisfactory rating at its previous CRA examination conducted as of September 20, 1999.

Description of Assessment Area

First State Bank has defined an assessment area of 12 census tracts that comprise the city of Flagstaff in its entirety and portions of census tracts that extend slightly beyond the city boundary. Flagstaff is situated in Northern Arizona, approximately halfway between the city of Phoenix and the Grand Canyon. The city of Flagstaff is located in the center of the Flagstaff, Arizona-Utah Metropolitan Statistical Area (Flagstaff MSA), which is composed of all of Coconino County. Approximately 46 percent of MSA inhabitants live in the city of Flagstaff.

FSB faces considerable competition, as demonstrated by the concentration of assessment area deposits in three large, multi-state banks, which together hold 71 percent of the market share. As of June 30, 2002, FSB maintained \$28 million in deposits, held five percent of the deposit market share, and ranked sixth out of seven thrifts and banks operating 20 offices within the assessment area.¹ The bank also faces considerable competition for small business loans, with 48 aggregate lenders granting 2,546 small business loans for \$66 million in 2001.

The following table illustrates some of the 1990 Census data, the most recent finalized census, used to develop the performance context. The assessment area includes no low-income tracts.

Census Tract Income Level	Census Tracts		Population by Census Tract		Families by Census Tract	
	Number	Percent	Number	Percent	Number	Percent
Moderate	3	25%	14,681	31%	1,961	20%
Middle	5	42%	17,729	38%	3,868	40%
Upper	4	33%	14,881	31%	3,921	40%
Total	12	100%	47,291	100%	9,750	100%

Flagstaff's population has grown significantly in recent years. Preliminary 2000 census data reflected steady growth of 12 percent since 1990 and estimated that the population was 52,894. In contrast, approximations provided by the Arizona Department of Commerce revealed a boom between 2000 and 2002, when the population increased an additional 12 percent, to 59,160.² Community contacts indicate that the population growth outpaced the development of housing and job growth, making both affordable housing and business financing significant credit needs.

Housing

Demand for housing rose dramatically during the examination period, and resulted from both population growth and Flagstaff's increasing attractiveness as a location for second homes to members of outside communities. The supply of luxury housing has increased significantly, but that of affordable housing has not kept pace with community needs. These circumstances have

¹ Federal Deposit Insurance Corporation, Individual Banks, *Deposit and Market Share Report*, June 2002 (accessed February 10, 2003); available from <http://www3.fdic.gov/sod/sodMarketRpt.asp>.

² Arizona Department of Commerce, Communities & Counties, *Community Profile* (accessed February 10, 2003); available from <http://www.commerce.state.az.us/doclib/COMMUNE/flagstaf.pdf>.

resulted in a 25 percent increase in the median housing prices during the examination period, which has far outpaced the 10 percent increase in the median family income.^{3,4} The following comparison provides further evidence of the disparity between the housing costs and family incomes. Though a 2002 home purchase in Flagstaff demanded 18 percent more than the national average home price, the area's 2002 median family income of \$48,200 was only 82 percent of the national median family income.^{5,6}

Industry

According to the Arizona Department of Commerce (DOC), Flagstaff is a center for government, education, transportation, culture and commerce. Government is one of the largest industry employers in the area, utilizing 26 percent of the workforce.⁷ Major government employers include Northern Arizona University (the largest single employer), Coconino Community College, and various state, local, and federal government offices.⁸ Tourism also is a major source of employment. Retail trade and service industries make use of 27 and 21 percent of the work force, respectively.⁹ Consistent with other communities where retail and service industries are increasingly concentrated, retail and service jobs are not necessarily high paying or even full-time. However, new scientific and high tech research and development companies have recently relocated to Flagstaff and are providing higher paying positions. Two such businesses, the Flagstaff Medical Center, Inc. and W.L. Gore & Associates, Inc. are the second and third largest employers in the area, employing over 1,000 workers each.¹⁰ The presence of these new industries began to establish parity between labor rates and the cost of living. According to community contacts, however, due to limitations on the number of jobs currently provided by new industries, commercial expansion credit remains a significant need.

The following table details the business distributions within the assessment area. Although effective loan demand is the result of various micro- and macroeconomic factors, small businesses comprise a large percentage of total businesses in the area and indicate potentially strong demand for loans. Community contacts corroborated that there is a need for small business loans and loans in small dollar amounts.

³ 2002 Economy.com, Inc., *Precis Metro Area Reports, Flagstaff*, December 2002.

⁴ U.S. Department of Housing and Urban Development, *Data Sets, 2002 Income Limits, 1989 & Estimated 2002 Decile Distributions of Family Income by Metropolitan Statistical Areas and Non Metropolitan Counties* (accessed February 10, 2003); available from <http://www.huduser.org/datasets/il/fmr02/prt02med.pdf>.

⁵ ACCRA Cost of Living Index, *Comparative Data for 314 Urban Areas*, Volume 35, No. 4, ISSN 0740-7130, Data for Fourth Quarter 2002.

⁶ U.S. Department of Housing and Urban Development, *Data Sets, 2002 Income Limits, Estimated Median Family Incomes for FY 2002* (accessed February 10, 2003); available from <http://www.huduser.org/datasets/il/fmr02/medians.pdf>.

⁷ 2002 Economy.com, Inc., *Precis Metro Area Reports, Flagstaff*, December 2002.

⁸ *Ibid.*

⁹ *Ibid.*

¹⁰ *Ibid.*

Census Tract Income Level	Census Tracts		Dun & Bradstreet			
	Number	Percent	Number Small Businesses	Percent Small Businesses	Number Total Businesses	Percent Total Businesses
Moderate	3	25%	959	26%	1,250	25%
Middle	5	42%	1,973	52%	2,650	53%
Upper	4	33%	816	22%	1,089	22%
Total	12	100%	3,748	100%	4,989	100%

Economic Conditions

Despite recent world events which caused local economic contraction in 2001, Flagstaff's economy has experienced steady improvement since 1999. In the days after September 11, 2001, many industries shed jobs, including manufacturing and construction. As a result of recent state budget crises, the government also cut payrolls. However, job declines were offset by the addition of scientific and research businesses and modest growth in service and trade industries. The combination of new industries and general stability of remaining industries facilitated a steady decline in the unemployment rate from 6.6 percent in 1999 to 5.6 percent in 2000 and 5.3 percent in 2001.¹¹ The unemployment rate remained steady in 2002 at 5.3 percent.¹²

Though there were fluctuations in Flagstaff's economy, residential building activity continues to be robust, thanks to mortgage rates near record lows. Both permit issuance and home price appreciation have been experiencing growth above the state and national averages.¹³

Conclusions

The local economy has been relatively resilient due to the emergence of new industries and the modest growth of the retail and service industries, which employ the majority of the workforce and represent a significant portion of small businesses. Throughout the time period in review, small businesses remained viable. Community representatives contended that demand for small business loans remained commensurately steady, creating ongoing opportunities for banks that focus on small business lending.

¹¹ 2002 Economy.com, Inc., Precise Metro Area Reports, *Flagstaff*, December 2002

¹² Ibid.

¹³ Ibid.

CONCLUSIONS WITH RESPECT TO PERFORMANCE CRITERIA

Scope of Examination

The CRA performance of First State Bank was evaluated using the small bank examination procedures. The evaluation was based upon the following performance criteria.

- Loan volume in comparison to deposits (Loan-to-Deposit Ratio).
- Lending inside and outside the assessment area (Lending in Assessment Area).
- Distribution of lending to businesses with different annual revenues (Lending Distribution by Business Revenue).
- Dispersion of lending throughout census tracts or geographic areas within the assessment area (Geographic Distribution of Loans).

Responsiveness to consumer complaints was not evaluated, as the bank has not received any CRA-related complaints.

The CRA evaluation was based on 128 small business loans extended during the sample period of October 1, 2000, through September 30, 2002. Only those loans extended inside the assessment area were included in the Geographic Distribution of Loans and Lending by Business Revenue evaluations.

Loan-to-Deposit Ratio

FSB's loan-to-deposit ratio meets standards for satisfactory performance. Quarterly loan-to-deposit ratios since the 1999 examination averaged 68 percent. This ratio is reasonable in comparison to the national peer bank average of 71 percent and the state peer bank average of 80 percent.

Lending in Assessment Area

The concentration of lending meets standards for satisfactory performance. FSB extended a majority of small business loans, 79 percent, within the assessment area.

Lending by Business Revenue

Lending to businesses with different gross annual revenues exceeds standards for satisfactory performance. A substantial majority of loans originated, 76 percent by number and 69 percent by dollar volume, were to businesses with gross annual revenues of \$1 million or less. The concentration of lending to small businesses was almost twice that of aggregate lending levels of 41 percent. In addition, despite a decline in small businesses, from 89 percent of total businesses in 1999, to 75 percent in 2002, FSB maintained lending levels commensurate with the concentration of small businesses. Finally, loans less than \$100,000 composed 74 percent of FSB's total business credits, which was also considered favorable given the preponderance of small businesses and the articulated credit needs of those businesses.

Geographic Distribution of Loans

The geographic distribution of lending meets standards for satisfactory performance. As illustrated by the following table, the distribution of loans by number in each census tract income level was favorable in comparison to the distribution of businesses and aggregate lending.

Census Tract Income Level	Business Concentration	Bank Small Business Lending				Aggregate Small Business Lending	
		Number	Percent	Amount	Percent	Number	Amount
Moderate	25%	20	30%	\$1,139	18%	22%	36%
Middle	53%	39	57%	\$4,421	70%	55%	48%
Upper	22%	9	13%	\$792	12%	24%	16%
Total	100%	68	100%	\$6,352	100%	100%	100%

The loan dollar concentration in middle-income tracts resulted largely from FSB granting a majority of its large dollar business credits in those geographies. In response to community demands for small business loans and due to regulatory restrictions that limit the size of a single credit any one bank may extend based on that bank's capital base, FSB extended few business credits larger than \$500,000. The presence of these few large credits in a small lending pool with a low average loan amount, skewed the distribution of lending toward middle-income tracts. Given this scenario, lending distributions were deemed reasonable.

Response to Complaints

First State Bank has not received any complaints relating to its CRA performance since the previous examination. Accordingly, this component was not used to determine the overall performance rating.

Compliance with Fair Lending Laws and Regulations

No violations of the substantive provisions of the anti-discrimination laws and regulations were identified at this examination. Additionally, there was no evidence of prohibitive lending practices.

GLOSSARY OF TERMS

Aggregate lending: The number of loans originated and purchased by all lenders subject to reporting requirements as a percentage of the aggregate number of loans originated and purchased by all lenders in the MSA/assessment area.

Block numbering area ("BNA"): Statistical subdivisions of a county for grouping and numbering blocks in non-metropolitan counties where local census statistical area committees have not established census tracts. BNAs do not cross county lines.

Census tract: Small subdivisions of metropolitan and other densely populated counties. Census tract boundaries do not cross county lines; however, they may cross the boundaries of metropolitan statistical areas. They usually have between 2,500 and 8,000 persons, and their physical size varies widely depending upon population density. Census tracts are designed to be homogeneous with respect to population characteristics, economic status, and living conditions to allow for statistical comparisons.

Community development: Affordable housing for low- or moderate-income individuals; community services targeted to low- or moderate-income individuals, activities that promote economic development by financing businesses or farms that meet the size eligibility standards of the Small Business Administration's Development Company or Small Business Investment Company programs (13 CFR 121.301) or have gross annual revenues of \$1 million or less; or, activities that revitalize or stabilize low- or moderate-income geographies,

Consumer loan: A loan to one or more individuals for household, family, or other personal expenditures. A consumer loan does not include a home mortgage, small business, or small farm loan. This definition includes the following categories of loans: motor vehicle, credit card, home equity, other secured loan, and other unsecured loan.

Family: Includes a householder and one or more other persons living in the same household who are related to the householder by birth, marriage, or adoption. The number of family households always equals the number of families; however, a family household may also include non-relatives living with the family. Families are classified by type as either a married couple family or other family, which is further classified into "male householder" (a family with a male householder and no wife present) or "female householder" (a family with a female householder and no husband present).

Full review: Performance under the lending, investment, and service tests is analyzed considering performance context, quantitative factors (e.g., geographic distribution, borrower distribution, total number and dollar amount of investments, branch distribution) and qualitative factors (e.g., innovation, complexity).

Geography: A census tract or a block numbering area delineated by the U.S. Bureau of the Census in the most recent decennial census.

Home Mortgage Disclosure Act ("HMDA"): The statute that requires certain mortgage lenders that do business or have banking offices in a metropolitan statistical area to file annual summary reports of their mortgage lending activity. The reports include such data as the race, gender, and the income of applications, the amount of loan requested, and the disposition of the application (e.g., approved, denied, and withdrawn).

Home mortgage loans: Include home purchase and home improvement loans as defined in the HMDA regulation. This definition also includes multifamily (five or more families) dwelling loans, loans for the purchase of manufactured homes and refinancings of home improvement and home purchase loans.

Household: Includes all persons occupying a housing unit. Persons not living in households are classified as living in group quarters. In 100 percent tabulations, the count of households always equals the count of occupied housing units.

Low-income: Individual income that is less than 50 percent of the area median income, or a median family income that is less than 50 percent in the case of a geography.

Limited review: Performance under the lending, investment, and service tests is analyzed using only quantitative factors (e.g., geographic distribution, borrower distribution, total number and dollar amount of investments, branch distribution).

Market share: The number of loans originated and purchased by the institution as a percentage of the aggregate number of loans originated and purchased by all lenders in the MSA/assessment area.

Metropolitan area: Any primary metropolitan statistical area ("PMSA"), metropolitan statistical area ("MSA"), or consolidated metropolitan area ("CMSA"), as defined by the Office of Management and Budget, with a population of 250 thousand or more, and any other area designated as such by the appropriate federal financial supervisory agency.

Moderate-income: Individual income that is at least 50 percent and less than 80 percent of the area median income, or a median family income that is at least 50 percent and less than 80 percent in the case of a geography.

Middle-income: Individual income that is at least 80 percent and less than 120 percent of the area median income, or a median family income that is at least 80 percent and less than 120 percent in the case of a geography.

Multifamily: Refers to a residential structure that contains five or more units.

Optional loans: Includes any unreported category of loans for which the institution collects and maintains data for consideration during a CRA examination. Also includes consumer loans and other loan data an institution may provide concerning its lending performance.

Owner-occupied units: Includes units occupied by the owner or co-owner, even if the unit has not been fully paid for or is mortgaged.

Qualified investment: A qualified investment is defined as any lawful investment, deposit, membership share, or grant that has as its primary purpose community development.

Small loans to business: A loan included in "loans to small businesses" as defined in the Consolidated Report of Condition and Income (Call Report). These loans have original amounts of \$1 million or less and are either secured by nonfarm nonresidential properties or are classified as commercial and industrial loans.

Small loans to farms: A loan included in "loans to small farms" as defined in the instructions for preparation of the Consolidated Report of Condition and Income (Call Report). These loans have original amounts of \$500 thousand or less and are either secured by farmland, including farm residential and other improvements, or are classified as loans to finance agricultural production and other loans to farmers.

Owner-occupied units: Includes units occupied by the owner or co-owner, even if the unit has not been fully paid for or is mortgaged.

Qualified investment: A qualified investment is defined as any lawful investment, deposit, membership share, or grant that has as its primary purpose community development.

Upper-income: Individual income that is more than 120 percent of the area median income, or a median family income that is more than 120 percent in the case of a geography.