

Information as of 10/14/08

TARP Capital Purchase Program
What is It and
What Does It Mean to Community Banks?



Treasury's TARP Capital Purchase Program

On October 14, 2008, under authority granted to Treasury under the EESA, it announced a voluntary Capital Purchase Program under which the Treasury will purchase up to \$250 billion par amount of senior preferred shares based upon a standardized term sheet

To date, the Treasury has entered into agreements to purchase approximately \$126 billion in senior preferred securities from the nine largest U.S. banks

Applications for qualifying institutions must be submitted before 5 p.m. (EDT) on November 14, 2008

Interested institutions should contact their primary federal regulator for specific enrollment details. Interested institutions should also check to ascertain the amount of preferred shares which they are authorized to issue and ascertain the existence or availability of an S-3 shelf registration statement

Other measures announced on October 14, 2008, include:

- ◆ Temporary guarantee of newly issued senior debt (before June 30, 2009) of all FDIC-insured institutions and their holding companies having a maturity of 3 years or less
- ◆ Temporary guarantee of all deposits in non-interest bearing deposit accounts (until December 31, 2009)
- ◆ Beginning October 27, 2008, broader backstop for commercial paper of 3 month maturity from high-quality issuers from all sectors of the economy

The Treasury Direct Investment Term Sheet

Qualifying Issuers:	Banks, Thrifts, BHCs and S&LHCs (not banks controlled by foreign banks, hedge funds, specialty lenders or “shadow” banks)
Investor:	US Treasury (UST)
Size:	Discretionary with Treasury. Subscription (face) amount of preferred must be : <ul style="list-style-type: none">◆ no less than 1% of risk-weighted assets, or◆ no more than 3% of risk-weighted assets With a cap of \$25 billion
Security/Ranking:	Senior to common stock and parity with existing preferred (except junior preferred); liquidation preference of \$1000 per share
Dividend:	5% per annum for 1st five years; reset at 9% thereafter. Dividend is cumulative
Term & Regulatory Capital Status:	Perpetual – Tier 1 (even though cumulative dividend)

The Treasury Direct Investment Term Sheet

Convertibility Feature:	None, but note 15% warrant coverage (discussed below)
Voting:	None, except with respect to (i) issuance of additional preferred stock senior to US preferred; (ii) a merger or acquisition, etc., which “adversely impacts” US preferred; and (iii) ability to elect 2 directors, after six missed dividends whether or not consecutive. (Note: UST will not vote common shares exercised in connection with warrant)
Callable:	Non callable for 3 years, except from proceeds of issuance of either common or Tier 1 perpetual preferred which constitutes at least 25% of the issue price (a QEO). After redemption of US preferred, issuer can redeem common held by UST as a result of the exercise of warrant at FMV
Restriction on Dividends:	Can’t pay dividends on common or other preferred if dividends not paid on US preferred No increase in common dividend during first 3 years while US preferred outstanding without UST consent No share repurchases, except benefit plan repurchase in ordinary course of business
Transferability:	No restrictions. Issuer to put up shelf registration statement and US has piggyback rights
Use of Proceeds	No restriction or admonition

The Treasury Direct Investment Term Sheet

Executive Comp:

Issuer and CEO, CFO and 3 other most highly compensated officers “shall modify or terminate” all executive comp arrangements to the extent necessary to comply with guidance including (1) no comp. that encourages too much risk, (2) clawbacks in the event of inaccurate financial statements, (3) prohibiting any severance in excess of a 3x payment , and (4) limit on annual deductions to \$500,000 per executive (IRS and Treasury to issue final guidance shortly)

Warrant:

To acquire 15% of preferred par amount at an initial strike price equal to FMV (20-day trailing average market price). If shareholders need to, but do not take action to, create sufficient common shares to accommodate the exercise within 18 months, the warrant exercise price declines 15% each 6 months after issuance date until it reaches 55% of original exercise price). (After 18 months exercise price is 55% of original FMV)

◆ Warrants must be exercised in 10 years. Cannot exercise more than 50% prior to the earlier of (i) December 31, 2009 or (ii) proceeds from QEOs equal to not less than 100% of the issue price of the US preferred

◆ Freely transferrable, except that only 50% are transferable prior to the earlier of (i) December 31, 2009 or (ii) proceeds from QEOs equal to not less than 100% of the issue price of the US preferred. Issuer to file shelf registration for warrants and underlying common stock (while held by UST are nonvoting); becomes voting once transferred

◆ If need shareholder approval for common and the shareholders do not approve it, US gets FMV

Process:

Applications due by 5 p.m. on **November 14, 2008**. Direction is to discuss application with primary federal regulator on specific enrollment details

Big questions about the Capital Purchase Program

- ◆ ***Which financial institutions can participate in Treasury's Direct Investment Program?***
 - U.S. Banks, thrifts, and their holding companies (would not include banks controlled by foreign banks or hedge funds or specialty lenders)
 - Will smaller institutions which are not SEC registrants and which are not eligible for use of Form S-3 be disadvantaged?
 - How about smaller institutions who do not have a class of preferred authorized to be issued?
- ◆ ***Who "really" benefits?***
 - 1st – JPM, Goldman Sachs, Citi, Bank of America, Wells Fargo, BONY/Mellon and State Street (who received \$126 billion in the aggregate)
 - 2nd – 20 or so larger regional banks who are "systemically" important
 - 3rd – Other banks and thrifts, without discrimination, based on size, form of organization, geography, type, or amount of assets
- ◆ ***It appears that \$250 billion is sufficient to cover the entire industry (total industry risk-weighted assets are about \$11 trillion so that 1% would amount to \$109 billion and 3% would amount to \$326 billion)***
- ◆ ***What will the impact of a bank's primary federal regulator be on the process?***
- ◆ ***Price of admission is restrictions for three years on both growth of dividends and repurchases of other equity, with certain exceptions, and restrictions on executive compensation***

Preliminary thoughts regarding Treasury's Direct Investment Program and Debt Guaranty Program

- ◆ The Treasury is also defining the limitations in executive pay required for each program
 - Direct loan purchase program
 - Direct investment program
 - Auction program
 - Guarantee program
- ◆ *There is no assurance that this plan will cause banks to lend*
- ◆ *This plan may further exacerbate competitive pressures between larger and smaller institutions both for deposits and loans in discrete markets and put the little guys at a further competitive disadvantage*
- ◆ *Providing bridge/permanent capital to spur loan growth should also spur merger and acquisition activity*

Questions about direct investment

- ◆ **Will direct investment in some institutions cause destabilization of, or competitively disadvantage, other institutions?**
 - *Investment may serve as a federal endorsement of the recipient of the direct investment*
 - *Will government investment trigger cause a transfer of deposits and other customer relationships away from institutions which do not receive government investment?*
 - *Will propping up some banks (especially large banks) further tilt the competitive landscape between big banks and smaller banks and among banks of all sizes in discrete geographic markets?*
- ◆ **Note the direct investment program has no required role for private equity. Earlier commentary suggested a matching private/public program which was apparently eliminated. The terms proposed by the UST are considerably below current private equity expectations**
- ◆ **The nearest precedent for the Treasury's plan is the old Reconstruction Finance Corporation of the 1930s**

Other proposals being considered

- ◆ Reported proposal to guarantee all interbank lending
 - Such a program would be designed to enable banks to lend to one another on a risk free basis
 - Germany, France and the EU have adopted a program to guarantee interbank lending until the end of 2009
 - The EU will go further and provide a guarantee of all new medium term (up to 5 years) bank senior debt issuance

- ◆ Stimulus package for State and Local Governments
 - Reports regarding the current proposal would include tax relief in some form for families, extending unemployment insurance benefits beyond 39 weeks and expand the food stamp program
 - Additionally, as much as \$150 billion would go to states and cities to sustain their everyday spending
 - Rationale: While the nearly \$1 trillion that Congress and the Federal Reserve are making available to the financial system is intended to make credit available (supply), this stimulus package is designed to increase demand (and stop spending from further contracting)
 - State and local spending account for 12% of the U.S.'s economic activity, and there is widespread contraction in their spending because of lower revenues and laws that require them to balance their budgets

Our thoughts on Capital Purchase Program and TARP

- ◆ Pros, from the perspective of community banks
 - With new found liquidity and capital, big banks may stop irrational deposit pricing over time
 - Liquidity and capital and the presence of the TARP should *help* alleviate fears about community bank balance sheets and liquidity, which should *help* bring bank investors back into the market – facilitating complementary capital raises and decreasing the cost of capital for community banks, but this may take more time than we like
 - Ordinary loss treatment for write-downs of FNMA and FHLMC preferred securities is material
 - The elimination of the ceiling on deposit insurance for demand deposits is a big one for community banks
 - In time, banks should be more comfortable with one another and make excess liquidity available to each other at lower rates
 - ***The combination of:***
 - ***TARP, including the direct investment and guarantee alternative which provides buyers with capital and sellers to clean up the problems***
 - ***The lifting of the application of IRC 382 which restricted the use of net operating losses in the context of a change in control***
 - ***The Fed's relaxation of its change-in-control guidelines as it relates to private investment***
 - ***The tax-break accorded losses on FNMA and FHLMC preferred stock***
 - ***Clarification by the SEC to date on the application of FAS 157 to troubled banks (especially as it relates to purchase accounting marks)***
 - ***The addition of a portion of goodwill to Tier 1 capital to offset the DTL created by the deduction of goodwill for tax purposes***
- should all facilitate consolidation and should assist in attracting private equity into the troubled bank sector***

Our thoughts on Capital Purchase Program and TARP

◆ Cons

- Failure to receive a direct investment from the Treasury may carry stigma in the marketplace for investors, depositors and other banks, reminiscent of the nation's experience in the 1930s
- Aided and abetted by the legislation, the three biggest banks in the country now control 34% of the nation's deposits
- *Aided and abetted by the legislation, the big banks will compete more aggressively for loans and deposits with smaller banks*
- Morgan Stanley and Goldman Sachs are now banks, further exacerbating concentration and competitive issues
- *The big banks will consolidate larger regional and super-community banks, making some smaller community banks less relevant as sellers*
- The availability of third party bids and other inputs created by, or resulting from, the new TARP market will cause independent auditors to enforce FAS 157 and OTTI charges more aggressively, absent "clarification" from the SEC
- Additional regulatory oversight and additional cost is a given
- Potential premiums to be paid by the industry to the Guarantee and the TARP funds are a negative
- The potential for additional FDIC premiums and other industry assessments which will follow, will punish community banks for the excesses of the big banks
- Money market government insurance is not a good thing for banks

The TARP, even if successful, addresses only a part of our economic ills

- ◆ Housing Sector
 - Supply remains high, and demand, exacerbated by the current economic slow down, remains low. Pricing continues to decline
- ◆ Municipal Sector
 - Muni markets (especially short-term) are still shut down
- ◆ Consumer Sector
 - Consumer spending is down very, very sharply
- ◆ Foreign markets are also stressed – exports of U.S. goods and services are expected to decline significantly
- ◆ Hedge fund withdrawals, and Fund of Funds and hedge fund closings, have not decreased

Economists believe a recession is inevitable

A recession will not be good for community banks

- Business borrowings ↓
- Corporate defaults and C&I NPAs and NCOs ↑
- Mortgage borrowing ↓
- Consumer borrowing ↓
- Employment, disposable income, and savings ↓
- 4th quarter bank industry earnings ↓

Will this new program help stem the surging tide?

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