

Information as of 10/8/08

*The Troubled Asset Relief Program and
The Emergency Economic Stabilization Act of 2008*

*What is It and
What Does It Mean to Community Banks?*



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Glossary of Terms

CDS – Credit Default Swap

DTA – Deferred Tax Asset

DTL – Deferred Tax Liability

FAS 157 – GAAP mark-to-market rules

*FAS 141R – GAAP mark-to-market rules
applied to M&A transactions after
December 31, 2008*

FoF – Fund of Funds

FV – Fair Value

NI – Net Income

*NII – Net Interest Income
(interest income less interest expense)*

NIM – Net Interest Margin

*(net interest income as a percent of
average earning assets)*

MBS – Mortgage-Backed Securities

MRA – Mortgage-Related Assets

OTTI – Other-Than-Temporary Impairment

P&I – Principal and Interest

TARP – Troubled Asset Relief Program

WAC – Weighted Average Coupon

WAM – Weighted Average Maturity

The primary problem the legislation seeks to address is the banking crisis caused by bad assets banks and other financial firms can't sell

◆ Big banks and investment banks have...

- Securitized MBS residuals
- Stranded securitized real estate
- Repossessed MBS and other real estate collateral from prime brokerage loans
- Other “bad” real estate based loans
- Credit default swaps counterparty exposure

which results in...

- No liquid market for its MRAs
- Marked to market at low value per FAS 157 to reflect both asset quality deterioration and a lack of liquid market

which leads to...

- NIM and NI ↓
- Capital ↓
- Liquidity ↓
- Credit ratings ↓
- Depositor uncertainty about bank survival and the threat of runs on bank deposits ↑
- Interbank borrowing rates and deposit costs ↑
- Suppression of loan growth to maintain liquidity ↑
- Capital (debt and equity) formation ↓
- Stock prices ↓

This has created problems for banks which is adversely affecting the economy:

- ◆ Banks slowed lending to Main Street to conserve liquidity, stabilize asset quality and preserve capital
 - *Credit for Main Street borrowers is harder to get and more expensive, even from smaller, not-so-stressed banks*
- ◆ Big banks increased deposits to create liquidity by offering high rates
 - *Deposits cost more*
 - *Cost of funds (including LIBOR) go up dramatically – adversely impacting the stressed and non-stressed banks and their Main Street customers*
- ◆ Capital from conventional sources is not very available and the cost of capital continues to increase as investors avoid bank equity and debt markets

This has created problems for banks which is adversely affecting the economy:

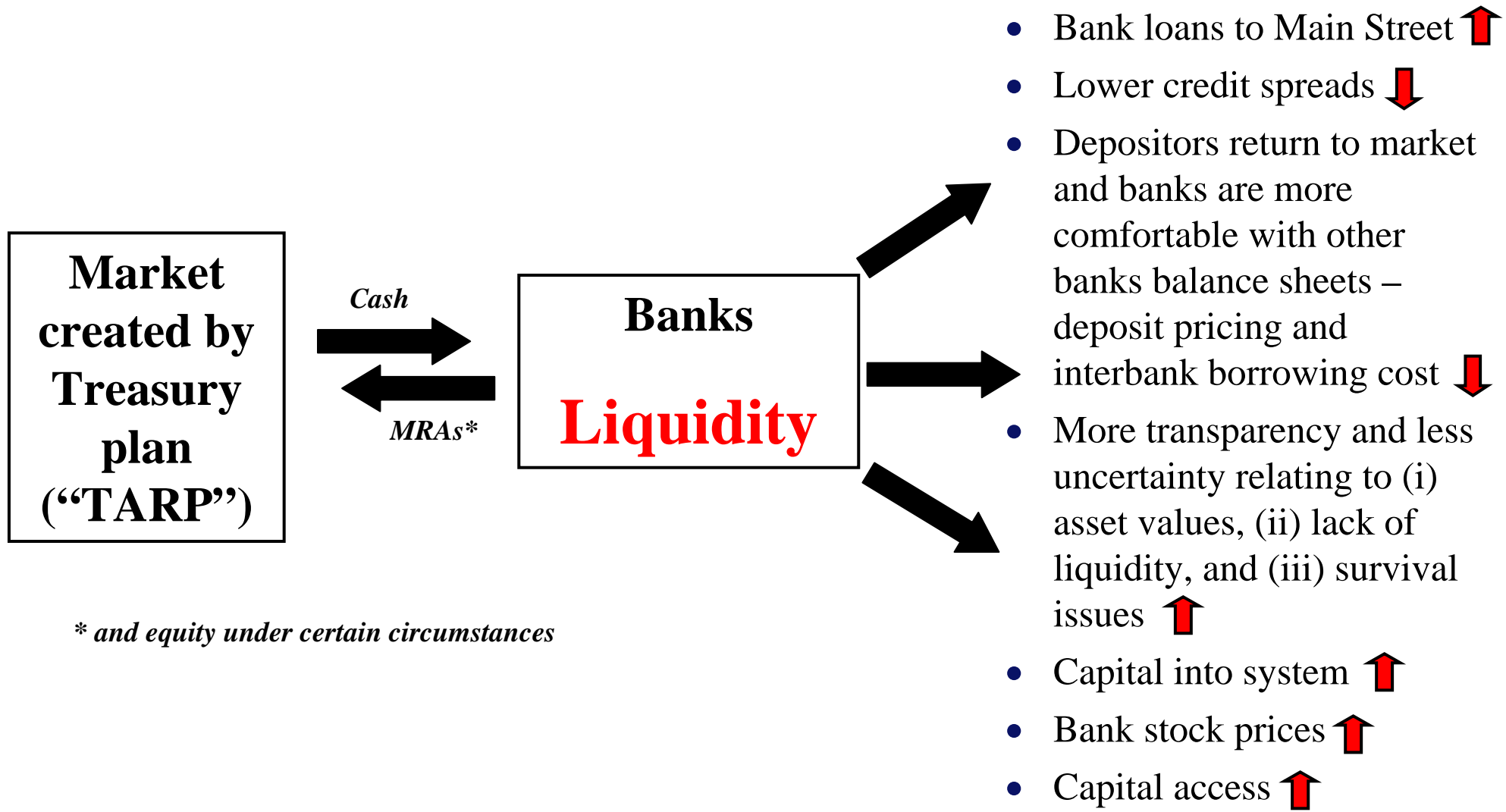
*which
leads
to...*

- Short-term credit to Main Street and industry ↓
- Long-term credit to Main Street and industry ↓
- Credit spreads for Main Street ↑
- Corporate spending and investment ↓
- Wages ↓
- Employment ↓
- Consumer spending ↓

Likely Recession

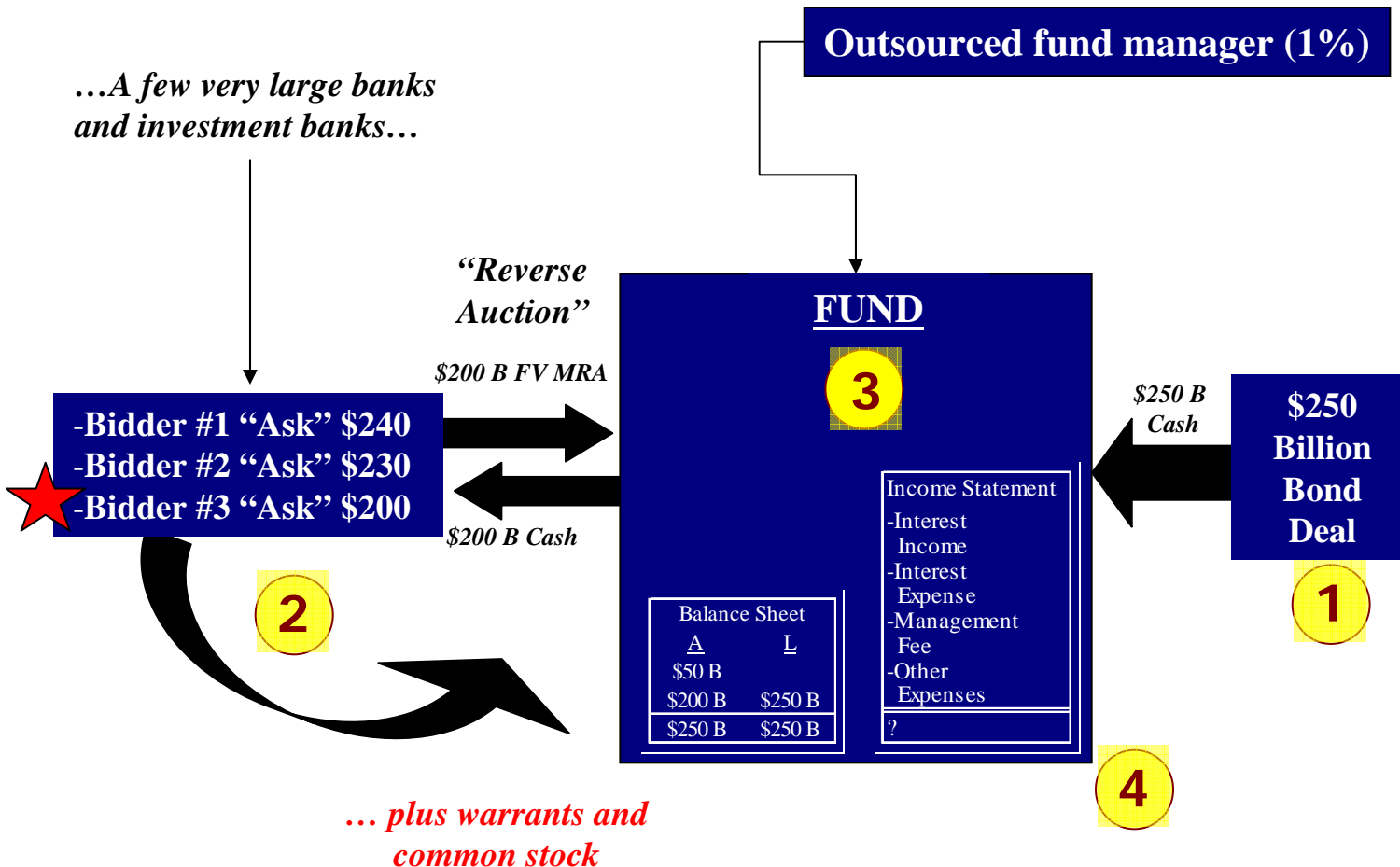
- Aug./Sept. unemployment ↑
- Aug./Sept. housing, auto and other retail sales ↓
- Aug./Sept. corporate investment and productivity ↓
- Hedge fund and FoF withdrawals ↑
- Consumer spending ↓

Goals: The Troubled Asset Relief Program



Solution No. 1: Treasury Asset Relief Program

Auction Deals – “Liquidity” *only*



1. Fund formed; \$250 Billion bond deal; outsourced management of fund

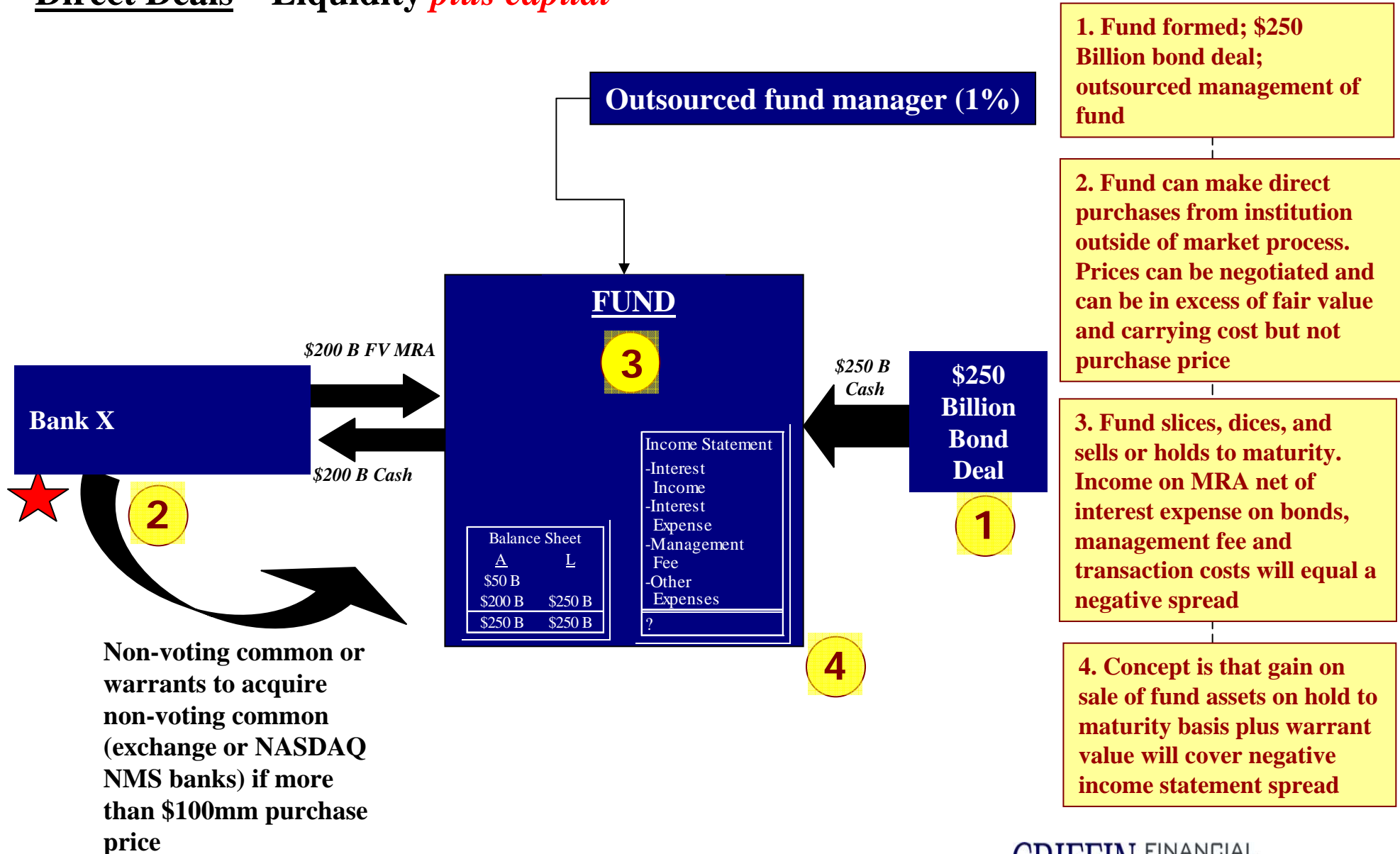
2. Fund runs reverse auction; fund bid specs for MRAs (WAM, WAC, delinquencies, etc.) and indicates “ceiling price”; banks bid “ask” price – low price (No.3) “wins” and tenders MRA for cash with maybe an equity sweetener

3. Fund slices, dices, and sells or holds to maturity. Income on MRA net of interest expense on bonds, management fee and transaction costs will equal a negative spread

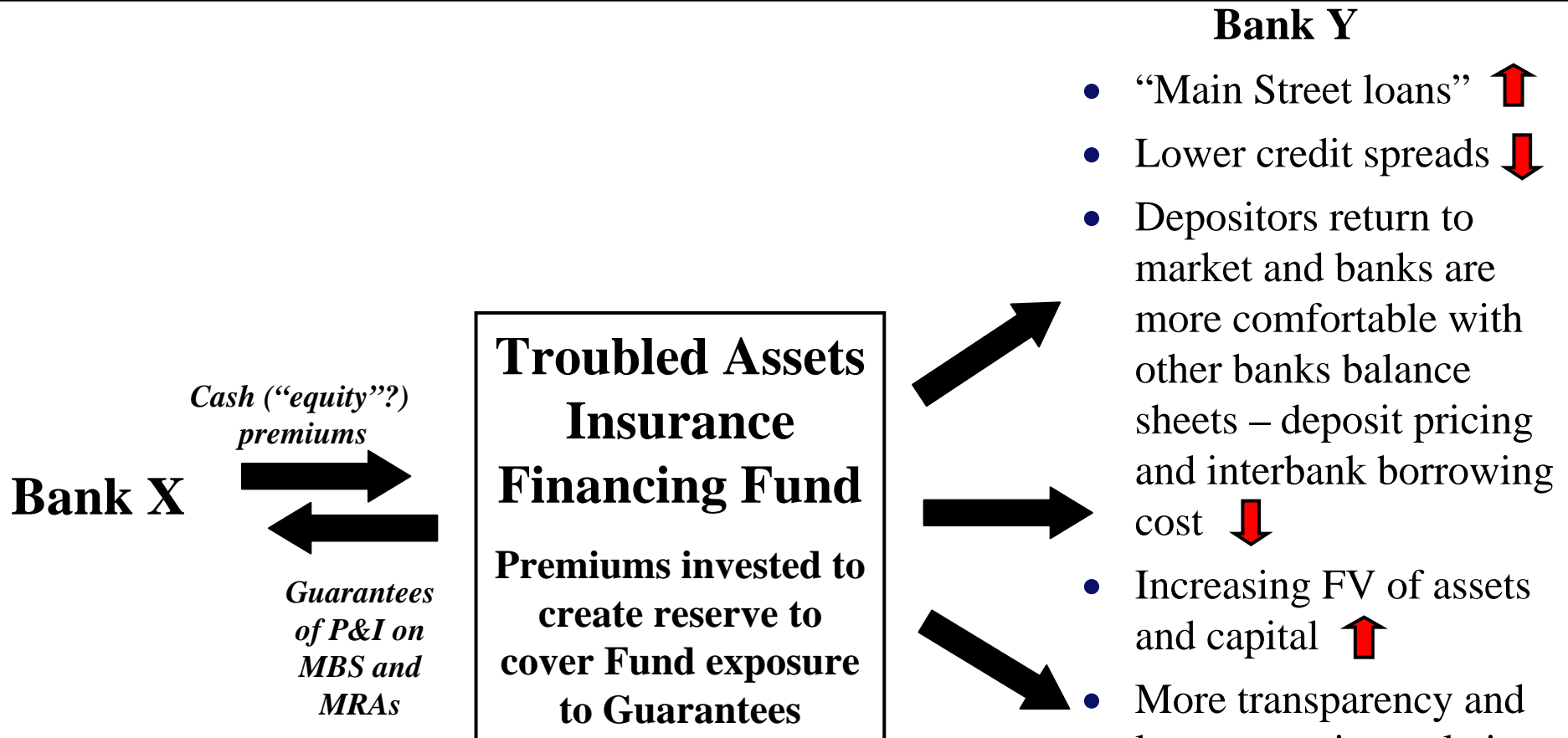
4. Concept is that gain on sale of fund assets on hold to maturity basis plus warrant value will cover negative income statement spread

Solution #2: Treasury Asset Relief Program

Direct Deals – Liquidity *plus capital*



Solution No. 3: Guarantee Fund



Note: Since the insurance premium required to be charged will be at market rates and at a level necessary to create reserves sufficient to meet anticipated claims (based on an actuarial analysis), under this solution premiums will be so high most companies cannot afford them (premiums paid in equity?)

Note: Wachovia/Citi/FDIC deal: common and warrants for loss protection, a form of guarantee

Big questions about the program?

- ◆ ***Which financial institutions can participate in TARP?***
 - U.S. Banks, thrifts, broker/dealers, credit unions and insurance companies; discretion to include other financial institutions
- ◆ ***What assets are subject to the program?***
 - Commercial and residential mortgages originated before 3/14/08
 - MBSs and other MRAs originated before 3/14/08
 - Any other “financial instruments” that are “based on or related to such mortgages” which the SEC and Chairman think should be covered (AIG’s underwater CDSs?)
- ◆ ***Who “really” benefits?***
 - 1st – JPM, Goldman Sachs, Citi, Bank of America, and AIG
 - 2nd – 10 to 15 big banks, investment banks and insurance companies, and probably some hedge funds as well
 - 3rd – Other banks and thrifts without discrimination based on size, form of organization, geography, or size, type, or number of assets
 - Main Street borrowers, to the extent liquidity equals loan growth

Big questions about the program?

◆ *At what asset price?*

- “At such terms and conditions as shall be set by Secretary,” can’t be over sellers “purchase price,” and no “unjust enrichment”
 - These provisions do not apply to those who acquire assets in conservatorship or receivership or through mergers or acquisitions
- At carrying value – windfall to shareholders of seller and creation of bank capital at expense of taxpayers
- Above carrying value – creates capital
- Below carrying value – creates capital hole. Capital is difficult to get and very expensive
- Can’t purchase troubled assets without receiving warrants to buy non-voting common stock or preferred stock, except under certain circumstances

◆ *How will banks fill up the capital hole from asset sales to TARP?*

- Big banks have Warren Buffett and Prince Alaweed
- Small banks - ??
- Some have proposed that Treasury inject capital in the form of perpetual preferred to fill up the hole – taxpayer preferred as to shareholders. This was not part of the bill

• **Direct sale of loans at a premium to FMV and carrying value, coupled with warrants or preferred stock will help fill up this hole**

◆ The Guarantee Fund

- Secretary may guarantee principal and interest of participating institution MBS and other MRA in exchange for premium (in cash or in equity) determined based on credit risk actuarially determined
- This will increase asset values and create capital
- *Can premiums be paid in equity?*
- This Fund could become an important part of the capital solution

Other key points in the legislation

- ◆ \$750 Billion - \$250B upfront; an additional \$100B upon certification by President; balance if not withheld by Congress
- ◆ Creates “Financial Stability Oversight Board” within Treasury with additional oversight from Special Inspector General, Comptroller General, Congressional panel, and judicial review
- ◆ Authorized Treasury to contract for services through streamlined process not subject to Federal Acquisition Regulations and issue regulations and guidelines regarding conflicts of interest
- ◆ Treasury authorized to create vehicles to purchase, hold and sell troubled assets and issue obligations
- ◆ Permits Treasury to create plan to mitigate foreclosure on assets it acquires when deemed appropriate (does this raise issues relating to acceleration of defaults by current borrowers who want the Treasury to restructure their loans?)
- ◆ Implicitly permits Treasury to acquire MRAs from FDIC as a receiver of a failed bank or from a DIP or trustee of a bankrupt holding company conservatorship transaction

Other provisions

- ◆ Secretary may not directly purchase troubled assets, or in an auction process, purchase troubled assets from a serial user, unless it receives from the financial institution:
 - Institutions trading on an exchange (including NASDAQ NMS): Warrant to receive equity (voting, non-voting or preferred stock converting into senior debt if cease to be listed)
 - Other institutions: Warrant to receive common or preferred stock or senior debt instrument
 - Exceptions: Not required to do so if the size of the cumulative transactions of troubled assets are not more than \$100 million.
 - Nominal amounts in auction. Treasury could own the bank in a direct sale
- ◆ Terms and price of warrants and senior debt are discretionary and to be designed for the benefit of taxpayers
- ◆ *The Federal Reserve will be able to pay interest on certain reserves of depository institutions that are held on deposit with the Federal Reserve starting on October 1, 2008*
- ◆ *Raises the FDIC and National Credit Union Share Insurance Fund deposit insurance limits from \$100,000 per account to \$250,000 until December 31, 2009. FDIC to borrow from Treasury to fund. Expect an increase in premiums*

Other provisions

- ◆ ***President to propose a method to recoup fund losses after 5 years of experience which may include assessing fees against the industry (over a certain asset size)***
- ◆ Limitations on compensation of executives who benefit from the plan
 - Direct purchases
 - Oversight over executive composition and corporate governance
 - Claw-back for bonuses paid where disclosures are false and misleading
 - No chute payments while debt or equity are held by Treasury
 - Auction purchases
 - If over \$300mm purchased by Treasury, no new chute agreements
 - If over \$300mm in purchases by Treasury, 162(m) cap will be \$500k for compensation in the applicable year for those who take advantage of the plan and, for deferred compensation, \$500k subject to adjustment
 - If over \$300mm in purchases by Treasury, any severance payments will be subject to 280G excise taxes
- ◆ ***Ordinary loss treatment for federal income tax purposes on losses realized on sale of FNMA and FLMC preferred stock (can net against ordinary income and not just capital gains)***
- ◆ No relief from FAS 157 and effective date of application of FAS 157 to FAS 141R adopted (initially proposed); requires SEC, in consultation with the Federal Reserve and Treasury, to conduct a study of FAS 157 and report to Congress within 90 days of enactment
- ◆ ***No legislative extension of short selling prohibition (initially proposed)***
- ◆ It is unclear whether the plan is broad enough to permit direct infusion of capital into struggling banks in connection with asset sales
- ◆ Secretary to “encourage” private sector to participate in purchases of troubled assets

Other provisions and related activities

- ◆ Declares as unenforceable any stand-still, confidentiality, or other agreements between a bank and a third party which restricts the third party from acquiring the deposits or assets of a bank that is, or is likely to be, in resolution (*the so-called “Wachovia/ Wells Fargo” provision*)
- ◆ In addition to the Emergency Economic Stabilization Act of 2008 , the financial rescue package contains two other components:
 - The Energy Improvement Act of 2008
 - Contains numerous tax provisions related to energy production, transportation, and energy conservation
 - Also includes several provisions that would raise revenue, with the largest effect from a modification of the requirements imposed on brokers for the reporting of their customers’ basis in securities transactions
 - Certain other provisions extending various expiring tax provisions, including alternative minimum tax relief
- ◆ Expiration of SEC short sale orders and no legislative provision to the contrary
- ◆ *Treasury Guarantee Program for mutual funds*
- ◆ FRB’s relaxation of rules on investments in banks
- ◆ The tax-break accorded losses on FNMA and FHLMC preferred stock
- ◆ The decision of the regulators to count a portion of accounting goodwill as Tier 1 capital

The legislation from the perspective of one community bank

- ◆ **There is no “panic” on Main Street concerning the soundness of most Main Street financial institutions. The problems are in the “high-risk”, highly levered financial institutions on Wall Street**
- ◆ **The primary beneficiaries of the rescue are Goldman Sachs, Morgan Stanley and JPMorgan. The Treasury is dominated by investment bankers, not commercial bankers. Treasury cannot be relied upon to craft a solution for Main Street**
- ◆ **Congress should not reward the poorly managed Wall Street institutions and their shareholders, and punish the well run regional institutions who are not stressed and who did not create or perpetuate this crisis, but they will. We will all pay**
- ◆ **Protecting the U.S. banking system, controlled by the Fed, makes sense. It does not make sense to bail out insurance companies, investment banks and broker/dealers**
- ◆ **Pricing must be at fair market value determined by a process. If the process means sales at below carrying value, so be it**
- ◆ **Fair value accounting should be eliminated immediately as to financial institutions. Proposed new merger accounting rules should also be deferred**
- ◆ **There should be no limits on executive compensation from the plan which will impact other than the direct beneficiaries of the plan**

Our thoughts

- ◆ This is a Wall Street, not community bank bailout
- ◆ It has failed to convince the market that it will break the back of the crisis
- ◆ It does not inject sufficient capital into the banking system – capital must come from a combination of public and private investors, other banks, and the government
- ◆ It does not address the supply/demand imbalance in the real estate sector which is the root of the crisis
- ◆ The executive compensation provisions may “chill” direct participation in the TARP
- ◆ Interest receivable on reserves are a positive
- ◆ Further rate cuts by the FED will most likely occur later in October, helping liability sensitive banks
- ◆ The FDIC’s agreement to share in losses in the aborted Citi/Wachovia transaction in exchange for warrants is a positive
- ◆ The battle for Wachovia between Citi and Wells Fargo, without government support, is a good sign for the industry. So is Warren Buffett’s investment in Goldman Sachs

Our thoughts

- ◆ Pros, from the perspective of community banks
 - With new found liquidity, big banks may stop irrational deposit pricing over time
 - Liquidity 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 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 direct purchase alternative in the TARP has the potential to create liquidity and restore capital. It may be advantageous for many smaller institutions with some asset quality/ liquidity issues

Our thoughts

- ◆ Pros, from the perspective of community banks, (continued)
 - 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 guarantee alternative*
 - *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

◆ Cons

- 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
- 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

◆ Market reaction supports this conclusion

- DJIA ↓
- S&P 500 ↓
- NASDAQ composite ↓
- LIBOR ↑
- Consumer spending metrics ↓
- FTSE ↓
- Other global markets ↓
- VIX index ↑

◆ 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

◆ Very, very low supply of short-term (investor) credit to commercial paper and muni markets is threatening to American business

◆ Foreign markets are also stressed – exports of U.S. goods and services are expected to decline significantly

◆ Hedge fund withdrawals, and FoF and hedge fund closings, increase

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 ↓