
Confidential

**Recent Changes to Fair Value Measurements &
Other Than Temporary Impairment Accounting**

What Does This Mean to Community Banks?



Information as of April 13, 2009

	<u>Page</u>
I Summary of Changes	3
II Overview of Fair Value Changes	6
– Decision Tree for Fair Value Measurements	12
III Our Take: Fair Value Changes	13
IV Overview of OTTI Changes	16
– Decision Tree for OTTI Charges	25
V Our Take: OTTI Changes	26
VI About Griffin	28

This is the eighth in a series of material designed to help community banks keep abreast of the challenges and opportunities since 2008 and continuing through 2009. Materials we have previously prepared can be found on our website - www.go2griffin.com. We plan to update as developments occur.

The information contained herein should not be considered accounting guidance. Please consult with your independent public accountants for guidance when appropriate.

Section I – Summary

Fair Value Revisions

- ◆ *May make financial institutions and investors more comfortable with employing Level 3 models for valuing and reporting financial assets and liabilities, resulting in lower write-downs and lower hits to capital*
- ◆ *If indeed illiquid or distressed prices were previously used to value assets on a widespread basis (a big question), the fair value revision will result in lower write-downs and lower hits to capital*
- ◆ *It is at present unclear how the market will view these changes. Many investors view the revisions as inconsistent with the SEC's goal of transparency. Model-based valuations require significant judgment and are also widely divergent*

OTTI Revisions

- ◆ *Will probably result in fewer impairment charges; net interest margin will better reflect actual yield and cash flows subsequent to a recorded OTTI charge*
- ◆ *The impact on earnings of recorded OTTI charges will probably be lessened because only the credit piece of a security impairment will flow through earnings (in most circumstances)*

Effective

- ◆ *Both changes will be effective for interim and annual periods ending after June 15, 2009*
- ◆ *Early adoption for interim and annual periods ending after March 15, 2009 is permitted*
 - *A company must adopt both of the new pronouncements simultaneously*

Note: On April 9, 2009 meeting the FASB also issued FSP FAS 107-1 and APB 28-1, which expands disclosures for fair value of financial instruments (within the scope of SFAS 107) and now requires the FAS 107 fair value disclosures in interim financial reports (APB 28-1); the timeframe for required and permitted early adoption is the same as for the FSPs for Fair Value and OTTI. If a company elects to early adopt FSP FAS 107-1 and APB 28-1, it must early adopt both of the FSPs for Fair Value and OTTI.

Terms

AFS – *Available for Sale (Securities)*

BV – *Book value*

FSP – *FASB Staff Position
(Interpretation of a SFAS)*

FV – *Fair Value*

HTM – *Held to Maturity (Securities)*

OCI – *Other Comprehensive Income*

OTTI – *Other-Than-Temporary
Impairment*

GAAP – *Generally Accepted Accounting
Principles*

Statements of Financial Accounting Standards (SFAS)

107 – *Disclosures about Fair Value
of Financial Instruments*

141(R) – *Business Combination
Accounting*

157 – *Fair Value Accounting*

Section II – Overview of Fair Value Changes

- ◆ Fair value – the price that would be received to sell the financial asset or paid to transfer the financial liability (i.e. exit price) in an *orderly transaction* between *willing* market participants
- ◆ SFAS 157 requires disclosure classification of assets and liabilities within a three-level hierarchy based on judgments about whether the inputs used to determine the fair value are observable or unobservable
 - Observable inputs reflect market-based (Level 1), or market-derived (Level 2) or information obtained from independent sources
 - Unobservable inputs reflect management estimates about market data (Level 3)
 - In order to fulfill the requirements of SFAS 157 and its disclosures a company would need to obtain an understanding of *how* the price was determined
 - This could mean calling brokers, pricing sources, and/or evaluating other information in the market
- ◆ Application of fair value defined in SFAS 157 increases the breadth of data institutions are required to consider and its relevance to the instrument being valued
- ◆ It also requires institutions to prepare more detailed documentation regarding data points not used in a fair value measurement

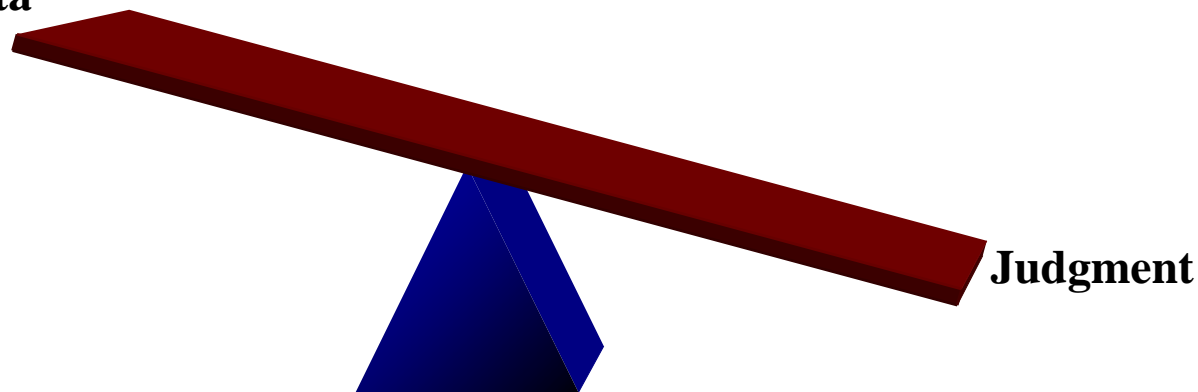
Why All the Hype About Fair Value Measurements?

- ◆ The “credit crisis” caused material shifts in investor expectations, which affected security pricing when compared to previous levels
- ◆ This generally meant that absent a change in an interest rate or creditworthiness, a security was worth less than it was previously because the risk premium increased
- ◆ Accounting rules require instruments measured at fair value to incorporate shifts in pricing levels if they are considered indicative of transactions between willing parties
- ◆ Also, certain institutions experienced stress and liquidity issues, and they were forced to sell investments at values some considered distressed
- ◆ There is a perception that markets remain illiquid and pricing of certain securities, which would ordinarily trade higher in an ordinary market, is required to be based on inputs from thin trading volume or distressed transactions
- ◆ SFAS 157 and its interpretations *always* allowed companies to apply judgments to these situations when determining fair value
- ◆ On April 9, 2009 the FASB issued FSP FAS 157-4 to provide clarification on identifying data points from inactive markets and distressed transactions

- ◆ For community banks, fair value guidance is most significant for
 - Available for Sale Investment Securities
 - Trading Securities
 - Held to Maturity Securities-disclosures (and impairment charges)
 - Loans accounted for at Fair Value
 - Assets acquired (loans, investments) and liabilities assumed (deposits, borrowings) in a business combination

- ◆ In preparing financial statements, institutions struggle with the balance between utilizing objective data directly from the market and exercising judgment to record an alternative fair value that may more closely reflect a transaction between a willing buyer and a willing seller in an orderly transaction

Objective Data

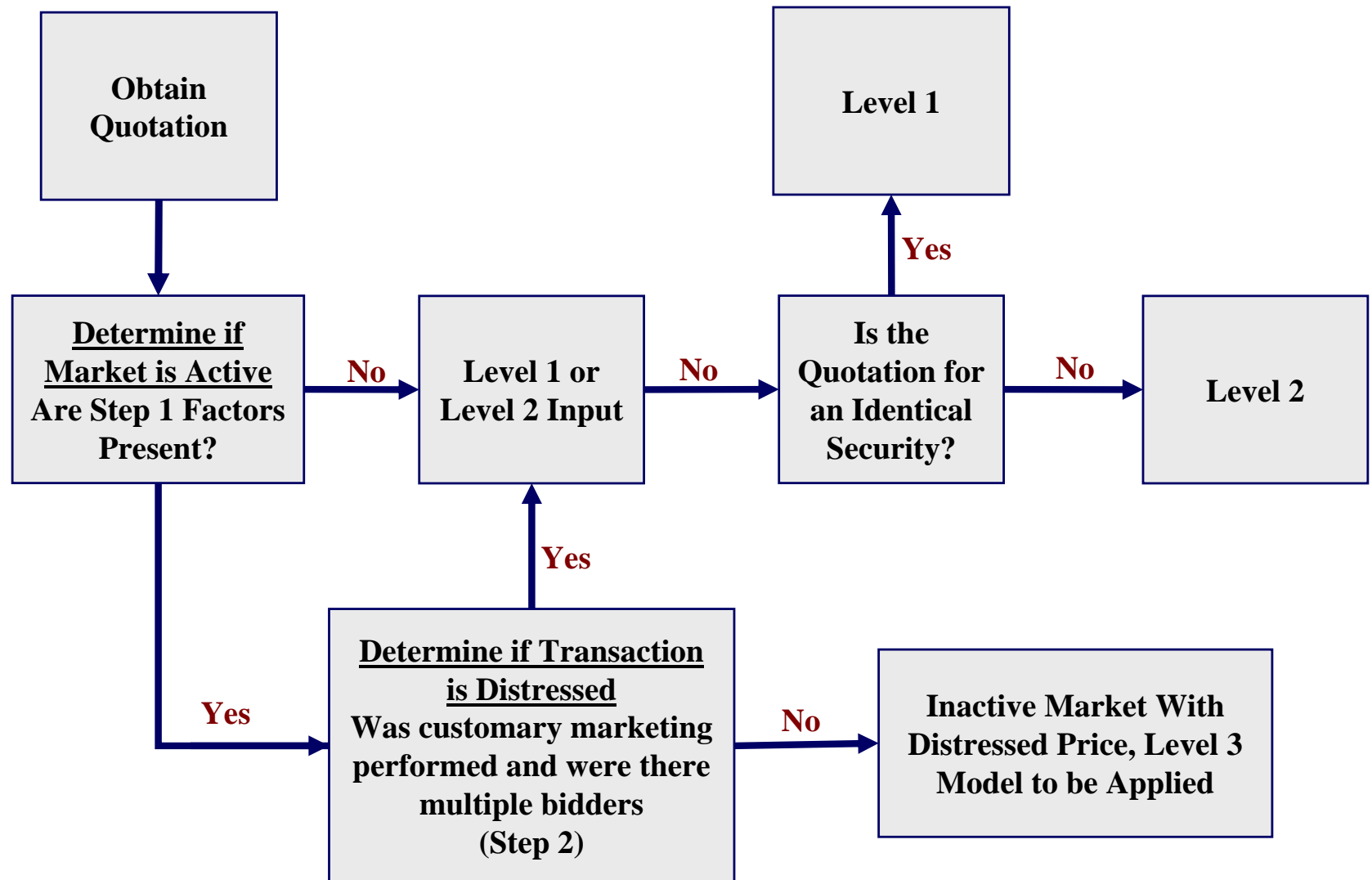


- ◆ In response to criticism that existing GAAP did not provide sufficient guidance for determining what constituted a distressed transaction or an inactive market, the FASB enacted clarifying guidance (FSP FAS 157-4) via
 - “... a two-step process to determine when a market is not active and when a transaction is not distressed”

- ◆ When an institution concludes a market is not active and transactions are distressed, (irrelevant) market data can be judgmentally excluded when determining fair value
 - Step 1 provides examples of factors that may lead a company to conclude, among others, a market is not active
 - Few, recent transactions (i.e. lack of volume)
 - Quotes based on noncurrent information
 - Substantial variation among quotes
 - Lack of correlation between an index and an asset (that was otherwise highly correlated)
 - Abnormal liquidity premiums or implied yields compared to other asset classes
 - Abnormally wide bid-ask spreads, or significant variation in bid-ask spreads over time
 - Little publicly available information

- Step 2 is applied if a company concludes that a market is not active based on the results of Step 1
 - Presume the quotation is associated with a distressed transaction, unless there is evidence
 - Customary sale marketing prior to the measurement date was performed **AND**
 - Multiple bidders participated in the process
- ◆ If Step 1 and Step 2 factors **both** exist, then the quotation is presumed to be not distressed
 - The quotation is presumed to be a relevant, observable input
 - Judgment can still be applied by a company as to whether to adjust the quoted price
 - Adjustments are item specific
 - Condition or location (e.g. loan file with missing documentation)
 - Comparability between items in quote vs. valued
 - Volume and/or level of activity in a market
 - The significance of a judgment made to an observable input may impact the classification between Level 2 and Level 3 inputs
- ◆ FSP FAS 157-4 will be effective for interim and annual periods ending after June 15, 2009 for prospective application only
- ◆ Early adoption for interim and annual periods ending after March 15, 2009 is permitted

Decision Tree for Determining Input Categorization



Section III – Our Take: Fair Value Changes

- ◆ What really changed for community banks?
 - Not much, despite the media characterizing this announcement as “easing” and “relief” and some analysts believing it could lift earnings by as much as 20%
 - Citigroup stated FSP 157-4 will have “no impact” in its financial statements. Bank of America CEO Ken Lewis stated the change might add “a penny or two” to earnings
 - There is now a non-inclusive list of factors to consider when determining whether or not a transaction is distressed or a market is not active
 - Believe it or not, it now seems more likely that a community bank would be required to consider an input than before if a community bank literally met the factors in Step 2
 - It still comes down to **JUDGMENT**
 - Companies still have to understand *how* quotations were determined before forming a conclusion by talking to brokers and pricing services among others

- ◆ Since SFAS 157 is a principles-based standard, it is unlikely that there will ever be an interpretation that does not end up with the use of judgment as an overriding factor
 - There are benefits to principles-based standards
 - More latitude for facts and circumstances based application
 - Opportunity to get ahead of issues with robust accounting policy memos
 - There are disadvantages to principles-based standards
 - Greater potential for disagreement between companies and their regulators, auditors, and the SEC
 - Increased chance of diverse accounting treatment of similar circumstances by competitors
 - Increased effort and work for applying a standard

Section IV – Overview of OTTI Changes

- ◆ Other-Than-Temporary Impairment (OTTI) is a charge recorded through earnings on a security that does not ordinarily have changes in fair value that flow through earnings
 - Investment Securities Available for Sale*
 - Investment Securities Held to Maturity*
- ◆ Prolonged, depressed market prices have made it increasingly difficult to not record OTTI without extensive analysis
- ◆ Each reporting period, GAAP requires an evaluation of securities whose fair value is below the carrying value for potential impairment
- ◆ As time passes, it becomes increasingly difficult to assert that a security is not impaired
 - Generally six months to a year is the window of tolerance

* Impairment can exist for securities other than these, but recent guidance affects these classes of securities most notably

- ◆ Common indicators of impairment include
 - Fair value is significantly below carrying value
 - Decline in Fair Value is due to a specific, adverse condition for an individual investment, industry, or geography
 - Rating agency downgrade or other issuer deterioration
 - Curtailment of dividends or interest payments
- ◆ Equity security impairments are nearly automatic after six to nine months below book value
- ◆ Rating agency downgrades need careful consideration
 - Near-term financial condition of the issuer
- ◆ Debt securities (and agency preferred securities) with fair values below cost for an extended period of time are likely to be considered impaired
 - There is a rebuttable presumption that OTTI exists after 6 to 12 months of consecutive fair value below carrying value, unless
 - It can be proven that the decline in fair value is not due to credit deterioration
 - Evidence exists to support that at least the carrying value of the security will be recovered

- ◆ The analysis can be particularly cumbersome for unique debt securities
 - May require deal and/or loan level cash flow analysis
- ◆ All analysis requires careful documentation and disclosure
- ◆ “Other-Than-Temporary” does not mean permanent
- ◆ A company’s financial condition and liquidity is just as important as security level considerations
 - Even if the security is likely to recover, if a company cannot support its “intent” and “ability” to hold a security until that point, OTTI must be recorded
 - Considerations of recent sale activities impact considerations of “intent”
 - Sales of similar securities at a loss adversely affect the ability to assert “intent” to hold to recovery but is not insurmountable

- ◆ On April 9, 2009 FASB issued FSP FAS 115-2 and FAS 124-2 (FSP on OTTI Impairment) to address concerns that significant components of recorded OTTI for debt securities did not relate to underlying credit losses for a security
- ◆ OTTI Existing Rules
 - Deterioration in price solely due to interest rate changes does not cause OTTI
 - When OTTI is recorded, the entire write-down is taken through earnings (including any component related to changes in interest rates and other components including risk premium spreads)
 - Company must assert that when a security is underwater that it has the positive intent and ability to hold the security to recovery, otherwise a charge must be recorded
- ◆ Revised OTTI Rules (for debt securities only)
 - Deterioration in price due to interest rate changes does not cause OTTI
 - When OTTI is recorded, the credit component write-down is taken through earnings (the remainder is permitted to remain in OCI, if certain criteria are met)
 - Company must assert when a security is underwater that it
 - Does not have the intent to sell the security
 - It is more likely than not (> 50%) that it will not sell the security before recovery

- ◆ Exceptions to separating credit and other components of OTTI charges
 - If management cannot assert that it does not intend to sell a security and
 - It is not “more likely than not” it will not sell a security
 - In other words – it does not intend to hold or is not likely to hold the security to recovery
 - The total write-down including spread and other factors is recorded through earnings
- ◆ Otherwise, the OTTI charge must be separated into credit and other components
 - The credit component is recorded through earnings
 - The other components recorded through other comprehensive income (OCI)

◆ Disclosure and Reporting

- The total charge is shown on the income statement, with the portion reclassified into OCI being shown as a reduction to the total

– Example:

Total OTTI Losses	\$ 100mm
Portion of OTTI recognized in OCI (pre-tax)	<u>\$ (10mm)</u>
Net Impairment Losses Recognized in Earnings	\$ 90mm

- The new security basis is the previous cost basis less the impairment recorded through earnings
 - The charge through earnings cannot be subsequently recovered
- OTTI charges for held-to-maturity securities recorded in OCI are amortized over the remaining life of the security, prospectively, by offsetting the recorded value
- Financial statement discussion must include identifying the credit and other components of OTTI, in addition to the applied methodology and key inputs for measuring the total impairment charge
- A company will no longer record the non-credit component of previously recognized OTTI in earnings
- AFS and HTM security holdings and related information on unrealized losses for which OTTI has not been recorded is required in interim financial statements (previously only in annual)
- A roll-forward of credit losses recorded in earnings is now a required disclosure
- A reclassification between OCI and retained earnings is recorded for previously recorded OTTI, at adoption

Recent Changes to (OTTI) Guidance



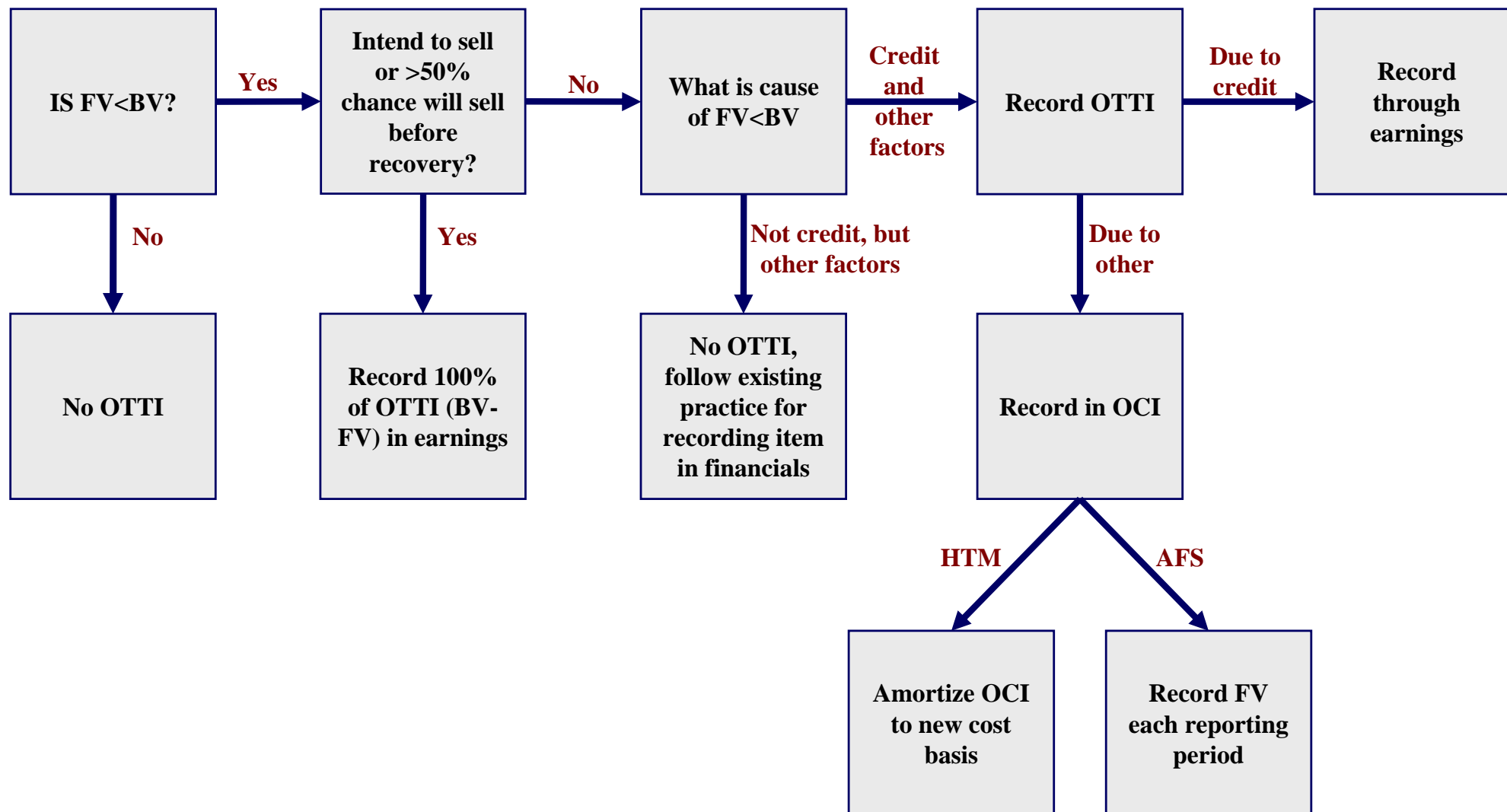
- ◆ The FSP will be effective for interim and annual periods ending after June 15, 2009
- ◆ Early adoption for interim and annual periods ending after March 15, 2009 is permitted
- ◆ A company must elect to adopt both of the new FSP's (OTTI and Fair Value) simultaneously

High Level Comparison of OTTI Guidance



	Other Loss Components	Credit Losses	Management Assertion
OTTI Existing	Does not cause impairment Reduce earnings if OTTI recorded	Causes impairment Reduce earnings via impairment charge	Intent and ability to hold impaired security to recovery
OTTI Revised	Does not cause impairment No effect on earnings if meet intent and ability criteria, reduction to OCI	Causes impairment Reduce earnings via impairment charge	Does not have intent to sell the security and more likely than not it will not have to sell before recovery

OTTI Decision Tree for Debt Securities



Section V – Our Take: OTTI Changes

Our Take: Other-Than-Temporary Impairment



- ◆ May require more detailed analysis, including employing valuation professionals to assist in determining the components of a security impairment
- ◆ May result in smaller charges recorded through earnings, which could incite increased frequency of OTTI charges (i.e. less resistance)
- ◆ Lower and more realistic hurdle for an institution to assert intent and ability to hold to recovery
 - Management committee and maybe board resolutions evidenced in meeting minutes may help provide key support
- ◆ No impact on tangible common equity
- ◆ Net interest margin is more representative of actual cash flows as the non credit component of OTTI is no longer subsequently accreted through yield

Section VI – About Griffin

- ◆ Griffin's Financial Institutions Group is part of an integrated professional services firm consisting of:
 - A FINRA licensed investment bank focusing on the financial services sector
 - A full service AmLaw 200 law firm focusing on the financial services sector
 - An SEC registered money manager focusing on the community bank sub-sector, with exceptional sector insights and exceptional track record
 - A private equity placement and due diligence business which understands the intersection between the financial institutions and private equity sectors
 - A D&O and E&O insurance risk consulting business focusing on the financial institutions sector
 - A tax consulting business which assists financial institutions manage its tax provision
 - Strong federal and state government affairs and several other businesses which focus on financial institutions and complement and expand our platform

Our Platform – How We Are Different



- ◆ Our Griffin Platform consists of over 240 multidisciplinary professionals covering the Northeastern U.S. from 17 offices
 - Our platform stresses the value of occupational and educational diversity and sector experience
 - In addition to sector experienced investment bankers, lawyers, placement agents, government affairs and investment professionals, our team members include former senior executive officers, accountants, tax professionals, risk managers, regulatory compliance officers, economists, swap advisors, and research analysts
 - *The inclusion of in-house, industry specific financial accounting and tax capabilities in Griffin is unique among investment banks specializing in the financial institutions sector*
- ◆ Our Griffin Platform stresses the value of understanding sector needs from its clients' perspective
 - Our staff includes many former senior executive officers of both large and small depository institutions, specialty lenders and others in the sector with hands-on operating and transactional experience
 - *Our professionals have managed and built both small multi-billion institutions growing them organically as well as via acquisition and then selling them. These capabilities are in addition to those of any other investment bank which generally lack professionals with any meaningful operating experience in the sector*
- ◆ Our Griffin platform also consists of transactional professionals with broad and deep and best of class bank and thrift experience comparable to or better than any of its competitors
- ◆ Our sector experience coupled with our occupational and educational diversity, multi-disciplinary approach and experienced transaction professionals combine to deliver exceptional value to our clients

Financial Institutions Group



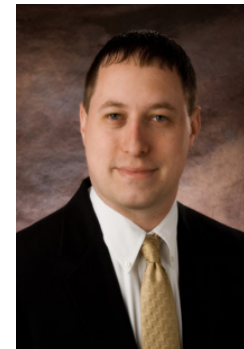
Our Financial Institutions Group includes former senior executives of banks and thrifts, financial accountants and tax accountants who understand the needs of our banking clients and their current technical accounting and tax issues from a financial perspective with an emphasis on its application to transactions and capital formation



Mark McCollom



Keene Turner



Mike Sobota



Mark Russell

- ◆ Former CFO at Sovereign Bancorp and Sovereign Bank where at different times had primary responsibility for the corporate development and M&A, treasury, financial accounting, SEC compliance, risk management, investor relations, tax and strategic planning functions
 - ◆ Worked in corporate development at the former Meridian Bancorp and was formerly with a Big 4 accounting firm
 - ◆ While at Sovereign, was instrumental in executing Sovereign's successful acquisitions and capital markets programs, which permitted Sovereign to grow to \$90 billion in assets
 - ◆ Certified Public Accountant
- ◆ Former Senior Audit Manager for Ernst & Young with responsibility for managing and coordinating audits and SOX 404 implementation for large and small cap banks, specialty lenders and private equity firms
 - ◆ Significant auditing and accounting experience including accounting for investment securities and OTTI, investment valuation techniques (including illiquid or privately held investments), derivatives and hedging activities, purchase accounting and related valuation, mortgage banking activities, goodwill impairment and other asset impairment/valuation considerations, securitization accounting and valuation, and foreign currency translation
 - ◆ Certified Public Accountant
- ◆ Former Senior Audit Manager for Deloitte & Touche LLP, where he led numerous client engagements. In this capacity, he was intimately involved in the accounting aspects of mergers and acquisitions and private and public placements of debt and equity
 - ◆ Focused on emerging accounting issues with emphasis on the ramifications of SFAS 141R, 157 and 159 on bank asset values and sales
 - ◆ Certified Public Accountant
- ◆ Former National Tax Product Development Manager at PricewaterhouseCoopers
 - ◆ Advises financial institutions on structural aspects and tax and related accounting ramifications of projects and has significant expertise in emerging tax and accounting issues including the ramifications of IRS Section 382
 - ◆ Certified Public Accountant and a lawyer with an MBA (Accounting/Finance concentration) and an LL.H. in Tax



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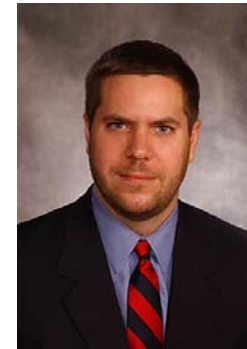
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Advisors with strong corporate finance and capital formation experience



Jeff Harenza

- ◆ Actively involved in intra-sector M&A, including marrying specialty finance companies and private equity sponsors with depository institutions
- ◆ Has participated in over 35 merger, acquisition and financing transactions in the financial institutions sector
- ◆ Advises banks, thrifts and specialty lenders in connection with sourcing alternative sources of capital, including private equity
- ◆ Participated in more than 25 due diligence reviews of stressed financial institutions in 2008 with an emphasis on determining real tangible book value



John McCausland

- ◆ 15 years of experience in the banking sector as an accountant and an investment banking and corporate finance professional, and has participated in over 30 merger and acquisition transactions
- ◆ Former Finance Manager of Profitability and Planning for the former Meridian Bancorp
- ◆ Strong quantitative and analytical experience in the banking, thrift and insurance sector, with an emphasis on mergers and acquisitions and the operational aspects of consolidations in the banking sector

Seasoned advisors with significant bank and thrift capital raising experience



Vince Thomas III

- ◆ Provides investment banking services to community banks and other financial institutions and assists them in finding and raising operational and growth capital
- ◆ Former Vice President with Anderson & Strudwick (A&S), a Virginia-based investment banking and brokerage firm
- ◆ Prior to joining A&S, served as an advisor to high net worth clients and institutions with a focus on financial institution stocks
- ◆ Formed a high net worth investment practice specializing in bank stock investments at Resource Bank, which was acquired by Fulton Bank, and previously worked in similar capacities at UBS and Davenport & Company in Virginia Beach, VA



David Payne

- ◆ Provides investment banking services primarily to de novo banks. For more than 10 years, he has been involved in myriad aspects of the industry, facilitating unique financial transactions and providing de novo consulting services in areas such as capital structure design, staffing, product design, business planning and capital funding issues. He is also responsible for assisting in mergers and acquisitions for banks and thrifts
- ◆ Previously worked at Merrill Lynch and was also an intelligence officer in the U.S. Navy, retiring as a Lieutenant Commander after 24 years of service
- ◆ Holds a J.D. from the Temple University School of Law and an M.S. in Counseling from the University of Scranton

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