

Information as of Nov. 12, 2008

***Update #4 on
TARP Capital Purchase Program
and Related Matters
and
What They Mean to Community Banks***

November 12, 2008



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Recent Developments

- ◆ *The deadline for applications for the Treasury's capital purchase program has not been extended. It remains 5:00 pm EST on Friday, November 14, 2008*, except for Sub S, mutual and other non-public companies with respect to which to date, no application, documents, or deadlines have yet been provided
- ◆ While TARP asset purchases have been non-existent, the TARP's capital purchase program is moving full steam ahead. Initially, 9 large institutions agreed to participate in the Program. Through Tuesday, 46 institutions have been approved for capital contributions and the total commitments by the Treasury total about \$176 Billion, with \$126 Billion of that already funded for the initial 9 banks

Recent Developments

- ◆ *Earlier today, the Treasury announced a new phase in its \$700 billion financial-rescue plan*
 - *It is considering requiring that banks seeking future government money raise private capital in order to qualify for TARP capital pursuant to a matching program*
 - *This would leverage the impact of a TARP investment by attracting private capital into the sector*
 - *This is expected to be in addition to the existing \$250 billion capital-purchase program*
 - *Treasury also announced it is unlikely to conduct any auctions to purchase bad loans and other troubled assets*
 - *Treasury is expected to widen its program to inject capital into smaller, sub-S, non '34 Act reporting, and mutual institutions, and is considering expanding its capital investment program to other nonbank financial institutions, such as insurers and specialty-finance companies*

- ◆ *Also earlier today, Secretary Paulson publicly outlined the remaining priorities for the TARP by outlining:*
 - *Strategies to stimulate the market for securitization of credit card, auto loan, and student loan receivables and similar products, as well as, new commercial and residential mortgage-backed securities through the creation of a liquidity guarantee program*
 - *A program to mitigate mortgage foreclosures, including the HOPE NOW Streamlined Loan Modification Program*

Recent Developments

- ◆ *Also today, the Treasury, the FDIC, and the Federal Reserve announced several regulatory initiatives applicable to banks. These programs include:*
 - Excessive Credit Tightening
 - The agencies expect that banks will not tighten underwriting standards excessively. The agencies fear slower, or no, loan growth and resulting damage to the economy if banks continue to sit on the sidelines. *The agencies have directed supervisory staffs to be mindful of the effects of excessive tightening of credit availability and to encourage banking organizations to practice economically viable and appropriate lending activities*
 - Excess Dividend Levels
 - The agencies caution banks to recognize losses on bank assets on a timely manner and maintain adequate loan loss provisions
 - *In setting dividend levels, the agencies warn that supervisors will continue to review the dividend policies of individual banks and will take action when dividend policies are found to be inconsistent with sound capital and lending policies*

Recent Developments

- Mortgage Foreclosures
 - The agencies expect banks to work with existing borrowers to avoid preventable foreclosures, and to mitigate other potential mortgage-related losses
 - Given escalating mortgage foreclosures, the agencies urge all lenders to adopt “systematic, proactive, and streamlined mortgage loan modification protocols” and to review troubled loans using these protocols
- Excessive Management Compensation
 - The agencies caution banks to regularly review their management compensation policies to ensure they are consistent with the longer-run objectives of the organization and sound lending and risk management practices
- ◆ It has been widely reported that the Treasury is now consulting with President-Elect Obama’s transition team, which raises the possibility of fundamental shifts in the administration and emphasis of the initiative

Recent Developments

- ◆ On November 11, American Express received approval to become a BHC, thus making it available for the TARP capital program; it follows Morgan Stanley and Goldman Sachs. GMAC and Chrysler Credit are said to also be seeking BHC status to access the TARP. For those companies to participate in the TARP capital purchase program, final approval of the holding company application must be obtained by December 31, 2008
- ◆ The Federal Reserve recently delayed, until later this month, its plan to support short term borrowings by mutual funds
- ◆ The Treasury released the form of preferred stock purchase and warrant documents late last week by posting it on its website:
 - The documents are identical in all material respects to the documents used for the initial 9 banks and discussed in our Update #3
 - The documents are of “one size -- fits all” variety and modifications are likely to be few and far between “if you want the money -- sign” approach
- ◆ Under the Treasury’s new plan for AIG, The banks who bought credit default swaps from AIG will be able to keep the collateral which secured AIG’s counterparty obligation, much of which resulted directly, or indirectly, from the first round of government assistance. ***The collateral amounts to about \$35 billion. The WSJ described it as a “home run” for the affected banks***
- ◆ Our comments and insights on the form direct investment documents posted late last week are set forth in the next section

Notes on Standard Documents

Strings?

- ◆ *Each bank recipient agrees in the preamble to the document to (i) “expand the flow of credit to U.S. consumers and businesses on competitive terms to promote the sustained growth and vitality of the U.S. economy,” and (ii) “work diligently, under existing programs, to modify the terms of residential mortgages as appropriate to strengthen the health of the U.S. housing market”*
 - There is nothing anywhere else in the document that defines or clarifies these broad undertakings
 - It is unclear what, if any, standards will be applied by the Treasury to effect compliance

Notes on Standard Documents

Strings?

- ◆ *Many have questioned whether or not strings will be attached to the TARP and if the government could interfere with banks' use of the capital, unilaterally modify the terms of the agreement or otherwise influence the affairs of the bank. These questions have been raised in public comments by members of Congress on the use of proceeds and history -- including the fate of goodwill and net worth certificates granted by regulators during the last banking crisis. They may be exacerbated by the preamble and the recently announced Streamlined Loan Modification Program*
 - Loan demand is weak right now through many parts of the nation. Construction loan demand is non-existent and many businesses are shrinking and do not want to take on additional debt. Consumers are likewise borrowing and spending less. Thus, it is unreasonable to assume that the TARP will cause an increase in lending in the near term because it will be muted by economic conditions. A high percentage of TARP capital will go to cushion loan losses and capital and support M&A
 - The documents do not restrict a bank's ability to use proceeds for acquisitions

Notes on Standard Documents

Participation

- ◆ The Treasury has made frequent statements to the effect that not every bank will be allowed to participate in either the asset purchase or capital purchase programs
- ◆ The regulatory selection process will likely create two classes of banks:
 - Banks who received approval
 - Banks who were rejected
- ◆ *We think that the Treasury is making its decisions based on CAMELS ratings, with substantial input from an applicants' primary federal regulator. In less clear cases, Treasury is relying upon a regulatory council made up of senior representatives of the four banking regulators for a joint review and recommendation*

Notes on Standard Documents

- ◆ Conventional thinking is, banks with:
 - A “composite 1” or “2” rating will be approved
 - A “composite 2” or “3” will be up for review, with emphasis on Capital Asset Quality and Management
 - A “composite 4” are a less likely possibility, and
 - A “composite 5” will not be accepted into the program.
- ◆ We know some banks who would not have been accepted to the Program because of capital, or potential capital, issues *but for* a commitment by the institution to raise additional capital especially from private sources. *The newly announced “match program” may be designed to facilitate this result*
- ◆ The Treasury will not publish the names of institutions approved for capital infusions. However, Treasury will publish electronic reports detailing any completed transactions, including the name of the institution, within 48 hours. No transactions have been completed since October 28, 2008
- ◆ Some banks who still fear the potential government involvement ultimately might decide not to participate in the program. Some of those banks – those with less than superior performance, and with less than superior asset quality and capital – will find it very hard to convince the market that they did not need or want the funds
- ◆ Banks in this category will probably face serious market valuation consequences from which they might not recover

Our Notes on the Standard Documents Which We Think You Might Want to Look At

Executive Compensation

- ◆ The documents require each senior executive to sign a letter at closing waiving any claims he or she may have against the bank and the Treasury as a result of changes to such executive's compensation arising from such modifications. The limitations on executive compensation and benefits remain in effect for each participating bank and its executive officers for so long as the Treasury continues to own any securities
- ◆ Loss of deduction for large severance payments
 - Prior guidance
 - Prior guidance under Section 162(m) had restricted the deduction limitations to those individuals who were the CEO or among the 4 highest compensated officers *on the last day of the taxable year*
 - An individual who had been terminated during the year was not subject to these limitations
 - Therefore, large severance payments were still deductible
 - TARP guidance
 - No limitation that a “covered executive” is determined on the last day of the taxable year
 - Therefore, if an individual is one of the highest paid officers at any time during a taxable year, it appears that no deduction of remuneration (including severance pay) in excess of \$500,000 is permitted
- ◆ ***Possible loophole in limitation of severance payments?***
 - ***Payment limitations apply to payments “on account of severance of employment”***
 - ***To the extent payments are made for other purposes, may not be limited***
 - ***For example – single trigger payments upon a change in control may not be limited***

Our Notes on the Standard Documents Which We Think You Might Want to Look At

Preferred Stock Redemption

- ◆ The preferred stock is optionally redeemable by the recipient, in whole or in part, only with the approval of its applicable primary federal regulator
 - During the first 3 years only if it has received aggregate cash proceeds of the issuance of a minimum (equal to 25% of the total liquidation preference of the preferred stock) of preferred or common equity qualifying as Tier 1 Capital (a “QEO”) in one or more offerings
 - If on or prior to December 31, 2009, the recipient generates **cash** proceeds from one or more QEOs equal to the aggregate liquidation preference of the preferred stock, the number of shares of common stock subject to the warrant will be reduced by 50%, *whether or not such proceeds are used to redeem the Preferred Stock*
 - ***This is intended to induce additional formation of Tier 1 capital by cutting dilution resulting from the warrant—a real inducement***
 - The QEO must have been announced after October 13, 2008
 - Note that there must be cash proceeds from the issuance of the QEO so stock issued in connection with M&A does not qualify

Our Notes on the Standard Documents Which We Think You Might Want to Look At

Warrant

- ◆ The warrant is exercisable immediately and is potentially dilutive and extremely valuable; the longer the maturity, the more valuable the warrant. ***The warrant cannot be redeemed while the preferred stock is outstanding.*** The warrant held by Treasury (and the common stock which is purchasable upon exercise of the warrant) may be redeemed only upon the redemption of the outstanding preferred from the Treasury in whole. *It cannot be taken out on a stand alone basis*
 - Note that Treasury can invoke an appraisal process in connection with redemption of the warrant and shares, as well as, in connection with any anti-dilution adjustment in connection with a non-cash distribution on the issuer's common stock
- ◆ The Treasury is limited from transferring or exercising more than half of the warrant prior to December 31, 2009
- ◆ The warrant exercise price is calculated on the date the Treasury preliminarily approves a bank's application for TARP and uses the trailing 20 trading day average price (not volume-weighted)
 - Thus, the bank has market risk between the date it applies and the acceptance date – e.g. if the market price drops, the exercise price drops
 - ***Please recollect that the warrant exercise price reduces by 15% at each 6 month anniversary of the issue if shareholder consent for the authorization of shares subject to the warrant is not received by each such date***
 - Generally, the warrants will be exercised on a cashless basis

Our Notes on the Standard Documents Which We Think You Might Want to Look At

- ◆ Anti-dilution provisions with respect to the warrant are customary with two exceptions
 - If a bank issues common stock at a discount to market of 10% or more, both the warrant exercise price and the number of shares purchased upon exercising of the warrant are adjusted (down and up respectively)
 - There is also no increase in the conversion ratio in the event of a cash merger
 - The exception to the anti-dilution provisions are customary and include shares issued in M&A transactions and shares issued in public or broadly marketed registered or Rule 144A offerings. *Note that there is no exceptions for the issuance of equity in private transactions and this will adversely affect placement with private equity*

Our Notes on the Standard Documents Which We Think You Might Want to Look At

Miscellaneous

- ◆ Dividends on the preferred stock are cumulative, and compound if unpaid at the quarterly dividend rate
 - If a bank is not a subsidiary of a BHC, dividends *are not* cumulative
 - The preferred stock qualifies without limitation as Tier 1 capital of such Participating Institutions *notwithstanding that dividends are cumulative*
- ◆ If the bank's common stock ceases to be listed on a national securities exchange while the warrant remains unexercised, the Treasury may require that the warrant be exchanged for an economic interest classified as GAAP permanent equity having an equivalent FMV determined by the bank's Board of Directors acting based upon an opinion of an expert. If the Treasury disputes the Board's valuation, there is a process specified for resolving the dispute
- ◆ The share repurchase prohibitions do not include:
 - Share repurchases for employee benefit plans consistent with past practice
 - Certain exchanges of securities by the bank
 - Share repurchases in connection with market making and related activities
 - Repurchases under stockholders' rights plans

Our Notes on the Standard Documents Which We Think You Might Want to Look At

Miscellaneous (con't)

- ◆ Each bank recipient is required to use reasonable best efforts to obtain stockholder approval of the potential issuance of the common stock purchasable upon exercise of the warrant and, if such approval is not obtained, to continue to seek such approval
- ◆ The Board is required to make representations and warranties for the documents regarding its business and regulatory affairs as of the closing. They must be reviewed carefully

Other Government Actions

- ◆ The SEC and more recently the FASB have confirmed that the warrants will receive equity accounting treatment
- ◆ The FDIC's Temporary Liquidity Guarantee Program insures newly issued senior unsecured debt and provides deposit insurance coverage for non-interest bearing transaction deposit accounts for up to 3 years
- ◆ Initially, entities had to decide whether to opt out by November 12, 2008. *Last week the FDIC extended the opt-out deadline to December 5, 2008*
- ◆ Beginning December 19, 2008, insured depository institutions must post signs informing their depositors whether they are participating in the TLGP, and all eligible entities must inform their customers whether they are participating in the debt guarantee portion of the program

Bank Deposits

- ◆ Money market deposit accounts, negotiable order of withdrawal accounts, and negotiable CDs are not covered, nor are deposits payable solely outside the U.S., including Eurodollar deposits
- ◆ Funds in sweep accounts are treated according to which kind of account they are transferred into. Funds swept into a non-interest bearing savings account from a non-interest bearing transaction account are treated as though they are in the transaction account

Unsecured Debt

- ◆ The senior unsecured debt eligible for coverage includes federal funds purchased, promissory notes, commercial paper, unsubordinated unsecured notes, certificates of deposit owed to a bank, deposits in international banking facilities owed to a bank, and Eurodollar deposits owed to a bank
- ◆ The guarantee is limited to 125% of the par or face value of the entity's senior debt outstanding, and will be calculated individually for each entity
- ◆ Once the entity reaches the 125% limit, the entity may continue to issue debt, but must disclose that it is not guaranteed
- ◆ After the 30 day opt-out period, eligible institutions will be charged a fee calculated by multiplying the amount of eligible debt guaranteed times the term of debt in years times 75 basis points
- ◆ With certain minor exceptions, "one size -- fits all" - the terms of the documents are the same for all

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