STERLING BANCORP
Form 10-K
March 16, 2009

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-K
Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the fiscal year ended December 31, 2008 — Commission File No. 1-5273-1

STERLING BANCORP
(Exact name of Registrant as specified in its charter)

New York	**13-2565216**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
650 Fifth Avenue, New York, N.Y.	**10019-6108**
(Address of principal executive offices)	(Zip Code)

(212) 757-3300
(Registrant's telephone number, including area code)

SECURITIES REGISTERED PURSUANT TO SECTION 12(B) OF THE ACT:

TITLE OF EACH CLASS	**NAME OF EACH EXCHANGE ON WHICH REGISTERED**
Common Shares, $1 par value per share	New York Stock Exchange
Cumulative Trust Preferred Securities 8.375% (Liquidation Amount $10 per Preferred Security) of Sterling Bancorp Trust I and Guarantee of Sterling Bancorp with respect thereto	New York Stock Exchange

SECURITIES REGISTERED PURSUANT TO SECTION 12(G) OF THE ACT: NONE

Indicate by check mark if the Registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes o No x

Indicate by check mark if the Registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes o No x

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No o

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. x

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company as defined in Rule 12b-2 of the Exchange Act. (Check one):

Large Accelerated Filer o Accelerated Filer x Non-Accelerated Filer o Smaller Reporting Company o
Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Act).
Yes o No x

On June 30, 2008, the aggregate market value of the common equity held by non-affiliates of the Registrant was $199,049,024.

The Registrant has one class of common stock, of which 18,106,491 **shares were outstanding at March 6, 2009**.

DOCUMENTS INCORPORATED BY REFERENCE

(1) Portions of Sterling Bancorp’s definitive 2008 Proxy Statement to be filed pursuant to Regulation 14A are incorporated by reference in Part III.

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Exhibits Submitted in a Separate Volume.

PART I

ITEM 1. BUSINESS

The disclosures set forth in this item are qualified by Item 1A. Risk Factors on pages 14–21 and the section captioned “FORWARD-LOOKING STATEMENTS AND FACTORS THAT COULD AFFECT FUTURE RESULTS” on page 25 and other cautionary statements set forth elsewhere in this report.

Sterling Bancorp (the “parent company” or the “Registrant”) is a bank holding company and a financial holding company as defined by the Bank Holding Company Act of 1956, as amended (the “BHCA”), which was organized in 1966. Sterling Bancorp and its subsidiaries derive substantially all of their revenue and income from providing banking and related financial services and products to customers primarily in New York, New Jersey and Connecticut (“the New York metropolitan area”). Throughout this report, the terms the “Company” or “Sterling” refer to Sterling Bancorp and its subsidiaries. The Company has operations in the New York metropolitan area and conducts business throughout the United States.

The parent company owns, directly or indirectly, all of the outstanding shares of Sterling National Bank (the “bank”), its principal subsidiary, and all of the outstanding shares of Sterling Banking Corporation and Sterling Bancorp Trust I (the “trust”). Sterling National Mortgage Company, Inc. (“SNMC”), Sterling Factors Corporation (“Factors”), Sterling Trade Services, Inc. (“Trade Services”), Sterling Resource Funding Corp. (“Resource Funding”) and Sterling Real Estate Holding Company, Inc. are wholly-owned subsidiaries of the bank. Trade Services owns all of the outstanding common shares of Sterling National Asia Limited, Hong Kong.

In September 2006, the business conducted by Sterling Financial Services Company, Inc. (“Sterling Financial”) was sold (see Note 2 on page 57). The results of operations of Sterling Financial have been reported as a discontinued operation and all prior period amounts have been restated as appropriate.

Segment information appears in Note 23 of the Company’s consolidated financial statements.

GOVERNMENT MONETARY POLICY

The Company is affected by the credit policies of monetary authorities, including the Board of Governors of the Federal Reserve System (the “Federal Reserve Board”). An important objective of the Federal Reserve System is to regulate the national supply of bank credit. Among the instruments of monetary policy used by the Federal Reserve Board are open market operations in U.S. Government securities, changes in the discount rate, reserve requirements on member bank deposits, and funds availability regulations. The Federal Reserve Board is currently using, and will continue to use, such instruments of monetary policy in its effort to strengthen market stability, improve the strength of financial institutions, and enhance market liquidity. The monetary policies of the Federal Reserve Board have in the past had a significant effect on operations of financial institutions, including the bank, and will continue to do so in the future. Changing conditions in the national economy and in the money markets make it difficult to predict future changes in interest rates, deposit levels, loan demand or their effects on the business and earnings of the Company. Foreign activities of the Company are not considered to be material.

BUSINESS OPERATIONS

The Bank

Sterling National Bank was organized in 1929 under the National Bank Act and commenced operations in New York City. The bank maintains twelve offices in New York: nine offices in New York City (six branches and an international banking facility in Manhattan and three branches in Queens); two branches in Nassau County (one in Great Neck and the other in Woodbury, New York) and one branch in Yonkers, New York. The executive office is located at 650 Fifth Avenue, New York, New York.

The bank provides a broad range of banking and financial products and services, including business and consumer lending, asset-based financing, factoring/accounts receivable management services, equipment leasing, commercial and residential mortgage lending and brokerage, deposit services, international trade financing, trust and estate administration, investment management and investment services. Business lending, depository and related financial services are furnished to a wide range of customers in diverse industries, including commercial, industrial and financial companies, and government and non-profit entities.

For the year ended December 31, 2008, the bank’s average earning assets represented approximately 99.8% of the Company’s average earning assets. Loans represented 60.4% and investment securities represented 39.3% of the bank’s average earning assets in 2008.

Commercial Lending, Asset-Based Financing and Factoring/Accounts Receivable Management. The bank provides loans to small and medium-sized businesses. The businesses are diversified across industries, and the loans generally range in size from $250,000 to $15 million.

Business loans can be tailored to meet customers' specific long- and short-term needs,

and include secured and unsecured lines of credit, business installment loans, business lines of credit, and debtor-in-possession financing. Loans are often collateralized by assets, such as accounts receivable, inventory, marketable securities, other liquid collateral, equipment and other assets.

Through its factoring subsidiary ("Factors"), the bank provides accounts receivable management services. The purchase of a client's accounts receivable is traditionally known as "factoring" and results in payment by the client of a nonrefundable factoring fee, which is generally a percentage of the factored receivables or sales volume and is designed to compensate for the bookkeeping and collection services provided by Factors and, if applicable, its credit review of the client's customer and assumption of customer credit risk. When Factors "factors" (*i.e.,* purchases) an account receivable from a client, it records the receivable as an asset (included in "Loans held in portfolio, net of unearned discounts"), records a liability for the funds due to the client (included in "Accrued expenses and other liabilities") and credits to noninterest income the nonrefundable factoring fee (included in "Accounts receivable management/ factoring commissions and other fees"). Factors also may advance funds to its client prior to the collection of receivables, charging interest on such advances (in addition to any factoring fees) and normally satisfying such advances by the collection of receivables. The accounts receivable factored are primarily for clients engaged in the apparel and textile industries.

Through a subsidiary, Sterling Resource Funding Corp., which was acquired on April 1, 2006, the bank provides financing and human resource business process outsourcing support services, exclusively for the temporary staffing industry. For over 25 years and throughout the United States, Resource Funding has provided full back-office, computer, tax and accounting services, as well as financing, to independently-owned staffing companies. The average contract term is 18 months for approximately 225 staffing companies.

As of December 31, 2008, the outstanding loan balance (net of unearned discounts) for commercial and industrial lending and factored receivables was $657.6 million, representing approximately 52.8% of the bank's total loan portfolio.

There are no industry concentrations in the commercial and industrial loan portfolio that exceed 10% of gross loans. Approximately 75% of the bank's loans are to borrowers located in the New York metropolitan area. The bank has no foreign loans.

Equipment Leasing. The bank offers equipment leasing services in the New York metropolitan area and across the United States through direct leasing programs, third party sources and vendor programs. The bank finances small and medium-sized equipment leases with an average term of 24 to 30 months. At December 31, 2008, the outstanding loan balance (net of unearned discounts) for equipment leases was $255.7 million, and equipment leases comprised approximately 20.5% of the bank's total loan portfolio.

Residential and Commercial Mortgages. The bank's real estate loan portfolio consists of real estate loans on one-to-four family residential properties and commercial properties. The residential mortgage banking and brokerage business is conducted through offices located principally in New York. Residential mortgage loans—focused on conforming credit, government insured FHA and other high quality loan products—are originated primarily in the New York metropolitan area, Virginia and other mid-Atlantic states, almost all of these for resale. Commercial real estate financing is offered on income-producing investor properties and owner-occupied properties, professional co-ops and condos. At December 31, 2008, the outstanding loan balance for real estate mortgage loans was $262.4 million, representing approximately 21.0% of the bank's total loans outstanding.

Deposit Services. The bank attracts deposits from customers located primarily in the New York metropolitan area, offering a broad array of deposit products, including checking accounts, money market accounts, NOW accounts, savings accounts, rent security accounts, retirement accounts, and certificates of deposit. The bank's deposit services include account management and information, disbursement, reconciliation, collection and concentration, ACH and others designed for specific business purposes. The deposits of the bank are insured to the extent permitted by law pursuant to the Federal Deposit Insurance Act, as amended.

International Trade Finance. Through its international division, international banking facility and Hong Kong trade services subsidiary, the bank offers financial services to its customers and correspondents in the world's major financial centers. These services consist of financing import and export transactions, issuing of letters of credit, processing documentary collections and creating banker's acceptances. In addition, active bank account relationships are maintained with leading foreign banking institutions in major financial centers.

Trust Services. The bank's trust department provides a variety of fiduciary, investment management, custody and advisory and corporate agency services to individuals and corporations. The bank acts as trustee for pension, profit-sharing, 401(k) and other employee benefit plans and personal trusts and estates. For corporations, the bank acts as trustee, transfer agent, registrar and in other corporate agency capacities.

The composition of total revenues (interest income and noninterest income) of the bank and its subsidiaries for the three most recent fiscal years was as follows:

Years Ended December 31,	**2008**	2007	2006
Interest and fees on loans	**53%**	59%	58%
Interest and dividends on investment securities	**25**	18	20
Other	**22**	23	22
	100%	100%	100%

At December 31, 2008, the bank and its subsidiaries had 562 full-time equivalent employees, consisting of 220 officers and 342 supervisory and clerical employees. The bank considers its relations with its employees to be satisfactory.

COMPETITION

There is intense competition in all areas in which the Company conducts its business. As a result of the deregulation of the financial services industry under the Gramm-Leach-Bliley Act of 1999, the Company competes with banks and other financial institutions, including savings and loan associations, savings banks, finance companies, and credit unions. Many of these competitors have substantially greater resources and may have higher lending limits and provide a wider array of banking services than the Company does. To a limited extent, the Company also competes with other providers of financial services, such as money market mutual funds, brokerage firms, consumer finance companies and insurance companies. Competition is based on a number of factors, including prices, interest rates, services, availability of products, and geographic location.

SUPERVISION AND REGULATION

General

The banking industry is highly regulated. Statutory and regulatory controls are designed primarily for the protection of depositors and the banking system, and not for the purpose of protecting the shareholders of the parent company. The following discussion is not intended to be a complete list of all the activities regulated by the banking laws or of the impact of such laws and regulations on the bank. It is intended only to briefly summarize some material provisions.

Sterling Bancorp is a bank holding company and a financial holding company under the BHCA and is subject to supervision, examination and reporting requirements of the Federal Reserve Board. Sterling Bancorp is also under the jurisdiction of the Securities and Exchange Commission and is subject to the disclosure and regulatory requirements of the Securities Act of 1933, as amended, and the Securities Exchange Act of 1934, as amended, as administered by the SEC. Sterling Bancorp is listed on the New York Stock Exchange (“NYSE”) under the trading symbol “STL” and is subject to the rules of the NYSE for listed companies.

As a national bank, the bank is principally subject to the supervision, examination and reporting requirements of the Office of the Comptroller of the Currency (the “OCC”), as well as the Federal Deposit Insurance Corporation (the “FDIC”). Insured banks, including the bank, are subject to extensive regulation of many aspects of their business. These regulations relate to, among other things: (a) the nature and amount of loans that may be made by the bank and the rates of interest that may be charged; (b) types and amounts of other investments; (c) branching; (d) permissible activities; (e) reserve requirements; and (f) dealings with officers, directors and affiliates.

Sterling Banking Corporation is subject to supervision and regulation by the Banking Department of the State of New York.

Bank Holding Company Regulation

The BHCA requires the prior approval of the Federal Reserve Board for the acquisition by a bank holding company of more than 5% of the voting stock or substantially all of the assets of any bank or bank holding company. Also, under the BHCA, bank holding companies are prohibited, with certain exceptions, from engaging in, or from acquiring more than 5% of the voting stock of any company engaging in, activities other than **(1)** banking or managing or controlling banks, (2) furnishing services to or performing services for their subsidiaries, or (3) activities that the Federal Reserve Board has determined to be so closely related to banking or managing or controlling banks as to be a proper incident thereto.

As discussed below under "Financial Holding Company Regulation," the Gramm-Leach-Bliley Act of 1999 amended the BHCA to permit a broader range of activities for bank holding companies that qualify as "financial holding companies."

Financial Holding Company Regulation

The Gramm-Leach-Bliley Act:

- allows bank holding companies, the depository institution subsidiaries of which meet management, capital and the Community Reinvestment Act (the "CRA") standards, to engage in a substantially broader range of non-banking financial activities than was previously permissible, including (a) insurance underwriting and agency, (b) making merchant banking investments in commercial companies, (c) securities underwriting, dealing and market making, and (d) sponsoring mutual funds and investment companies;

- allows insurers and other financial services companies to acquire banks; and

- establishes the overall regulatory structure applicable to bank holding companies that also engage in insurance and securities operations.

In order for a bank holding company to engage in the broader range of activities that are permitted by the Gramm-Leach-Bliley Act, (1) all of its depository subsidiaries must be and remain "well capitalized" and "well managed" and have received at least a satisfactory CRA rating, and (2) it must file a declaration with the Federal Reserve Board that it elects to be a "financial holding company."

Requirements and standards to remain "well capitalized" are discussed below. To maintain financial holding company status, the bank must have at least a "satisfactory" rating under the CRA. Under the CRA, during examinations of the bank, the OCC is required to assess the bank's record of meeting the credit needs of the communities serviced by the bank, including low- and moderate-income communities. Banks are given one of four ratings under the CRA: "outstanding," "satisfactory," "needs to improve" or "substantial non-compliance." The bank received a rating of "outstanding on the most recent exam completed by the OCC.

Pursuant to an election made under the Gramm-Leach-Bliley Act, the parent company has been designated as a financial holding company. As a financial holding company, Sterling Bancorp may conduct, or acquire a company (other than a U.S. depository institution or foreign bank) engaged in, activities that are "financial in nature," as well as additional activities that the Federal Reserve Board determines (in the case of incidental activities, in conjunction with the Department of the Treasury) are incidental or complementary to financial activities, without the prior approval of the Federal Reserve Board. Under the Gramm-Leach-Bliley Act, activities that are financial in nature include insurance, securities underwriting and dealing, merchant banking, and sponsoring mutual funds and investment companies. Under the merchant banking authority added by the Gramm-Leach-Bliley Act, financial holding companies may invest in companies that engage in activities that are not otherwise permissible "financial" activities, subject to certain limitations, including that the financial holding company makes the investment with the intention of limiting the investment duration and does not manage the company on a day-to-day basis.

Generally, financial holding companies must continue to meet all the requirements for financial holding company status in order to maintain the ability to undertake new activities or acquisitions that are financial in nature and the ability to continue those activities that are not generally permissible for bank holding companies. If the parent company ceases to so qualify, it would be required to obtain the prior approval of the Federal Reserve Board to engage in non-banking activities or to acquire more than 5% of the voting stock of any company that is engaged in non-banking activities. With certain exceptions, the Federal Reserve Board can only provide prior approval to applications involving activities that it had previously determined, by regulation or order, are so closely related to banking as to be properly incident thereto. Such activities are more limited than the range of activities that are deemed "financial in nature."

Payment of Dividends and Transactions with Affiliates

The parent company depends for its cash requirements on funds maintained or generated by its subsidiaries, principally the bank. Such sources have been adequate to meet the parent company's cash requirements throughout its history.

Various legal restrictions limit the extent to which the bank can fund the parent company and its nonbank subsidiaries. All national banks are limited in the payment of dividends without the approval of the OCC to an amount not to exceed the net profits (as defined) for that year-to-date combined with its retained net profits for the preceding two calendar years, less any required transfers to surplus. Federal law also prohibits national banks from paying dividends that would be greater than the bank's undivided profits after deducting statutory bad debt in excess of the bank's allowance for loan losses. Under the foregoing restrictions, and without adversely affecting its "well capitalized" status, as of December 31, 2008, the bank could pay dividends of approximately $21 million to the parent company, without obtaining regulatory approval. This is not necessarily indicative of amounts that may be paid or are available to be paid in future periods.

Under the Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA"), a depository institution, such as the bank, may not pay dividends if payment would cause it to become undercapitalized or if it is already undercapitalized. The payment of dividends by the parent company and the bank may also be affected or limited by other factors, such as the requirement to maintain adequate capital. In addition, in the current financial and economic environment, the Federal Reserve Board has indicated that bank holding companies should carefully review their dividend policy and has discouraged payment ratios that are at maximum allowable levels unless both asset quality and capital are very strong.

On December 23, 2008, we issued Series A Preferred Shares to the U.S. Treasury as a participant in the Capital Purchase Program under the Troubled Asset Repurchase Program. Under the terms of a letter agreement we executed in connection with the preferred shares issuance, prior to December 23, 2011, unless we have redeemed all such preferred shares or the U.S. Treasury has transferred all such preferred shares to a third party, the consent of the U.S. Treasury will be required for us to increase the dividend on our common shares above the current quarterly cash dividend of $0.19 per share.

For a discussion of additional restrictions on the Company's ability to pay dividends, see "Emergency Economic Stabilization Act of 2008" beginning on page 8.

Federal laws strictly limit the ability of banks to engage in transactions with their affiliates, including their bank holding companies. Such transactions between a subsidiary bank and its parent company or the nonbank subsidiaries of the bank holding company are limited to 10% of a bank subsidiary's capital and surplus and, with respect to such parent company and all such nonbank subsidiaries, to an aggregate of 20% of the bank subsidiary's capital and surplus. Further, loans and extensions of credit generally are required to be secured by eligible collateral in specified amounts. Federal law also requires that all transactions between a bank and its affiliates be on terms only as favorable to the bank as transactions with non-affiliates.

Federal law also limits a bank's authority to extend credit to its directors, executive officers and 10% shareholders, as well as to entities controlled by such persons. Among other things, extensions of credit to insiders are required to be made on terms that are substantially the same as, and follow credit underwriting procedures that are not less stringent than, those prevailing for comparable transactions with unaffiliated persons. Also, the terms of such extensions of credit may not involve more than the normal risk of repayment or present other unfavorable features and may not exceed certain limitations on the amount of credit extended to such persons, individually and in the aggregate, which limits are based, in part, on the amount of the bank's capital.

Banks are subject to prohibitions on certain tying arrangements. A depository institution is prohibited, subject to some exceptions, from extending credit to or offering any other service, or fixing or varying the consideration for such extension of credit or service, on the condition that the customer obtain some additional service from the institution or its affiliates or not obtain services of a competitor of the institution.

Capital Adequacy and Prompt Corrective Action

Banks and bank holding companies are subject to various regulatory capital requirements administered by state and federal banking agencies. Capital adequacy guidelines and, additionally for banks, prompt corrective action regulations, involve quantitative measures of assets, liabilities, and certain off-balance sheet items calculated under regulatory accounting practices. Capital amounts and classifications are also subject to qualitative judgments by regulators about components, risk weighting and other factors.

The Federal Reserve Board, the OCC and the FDIC have substantially similar risk-based capital ratio and leverage ratio guidelines for banking organizations. The guidelines are intended to ensure that banking organizations have adequate capital given the risk levels of assets and off-balance sheet financial instruments. Under the guidelines, banking organizations are required to maintain minimum ratios for Tier 1 capital and total capital to risk-weighted assets (including certain off-balance sheet items, such as letters of credit). For purposes of calculating the ratios, a banking organization's assets and some of its specified off-balance sheet commitments and obligations are assigned to various risk categories. A depository institution's or holding company's capital, in turn, is classified in tiers, depending on type:

- *Core Capital (Tier 1).* Tier 1 capital includes common equity, retained earnings, qualifying non-cumulative perpetual preferred stock, a limited amount of qualifying cumulative perpetual stock at the holding company level, minority interests in equity accounts of consolidated subsidiaries, less goodwill, most intangible assets and certain other assets.

- *Supplementary Capital (Tier 2).* Tier 2 capital includes, among other things, perpetual preferred stock not meeting the Tier 1 definition, qualifying mandatory convertible debt securities, qualifying subordinated debt, and allowances for loan and lease losses, subject to limitations.

Sterling Bancorp, like other bank holding companies, currently is required to maintain Tier 1 capital and "total capital" (the sum of Tier 1 and Tier 2 capital) equal to at least 4.0% and 8.0%, respectively, of its total risk-weighted assets (including various off-balance-sheet items, such as standby letters of credit). Sterling National Bank, like other depository institutions, is required to maintain similar capital levels under capital adequacy guidelines. For a depository institution to be considered "well capitalized" under the regulatory framework for prompt corrective action, its Tier 1 and total capital ratios must be at least 6.0% and 10.0% on a risk-adjusted basis, respectively.

Bank holding companies and banks are also required to comply with minimum leverage ratio requirements. The leverage ratio is the ratio of a banking organization's Tier 1 capital to its total adjusted quarterly average assets (as defined for regulatory purposes). The requirements necessitate a minimum leverage ratio of 3.0% for financial holding companies and national banks that have the highest supervisory rating. All other financial holding companies and national banks are required to maintain a minimum leverage ratio of 4.0%, unless a different minimum is specified by an appropriate regulatory authority. For a depository institution to be considered "well capitalized" under the regulatory framework for prompt corrective action, its leverage ratio must be at least 5.0%. The Federal Reserve Board has not advised Sterling Bancorp, and the OCC has not advised Sterling National Bank, of any specific minimum leverage ratio applicable to it.

The Federal Deposit Insurance Act, as amended ("FDIA"), requires, among other things, the federal banking agencies to take "prompt corrective action" in respect of depository institutions that do not meet minimum capital requirements. The FDIA sets forth the following five capital tiers: "well capitalized," "adequately capitalized," "undercapitalized," "significantly undercapitalized" and "critically undercapitalized." A depository institution capital tier will depend upon how its capital levels compare with various relevant capital measures and certain other factors, as established by regulation. The relevant capital measures are the total capital ratio, the Tier 1 capital ratio and the leverage ratio.

Under the regulations adopted by the federal regulatory authorities, a bank will be: (i) "well capitalized" if the institution has a total risk-based capital ratio of 10.0% or greater, a Tier 1 risk-based capital ratio of 6.0% or greater, and a leverage ratio of 5.0% or greater, and is not subject to any order or written directive by any such regulatory authority to meet and maintain a specific capital level for any capital measure; (ii) "adequately capitalized" if the institution has a total risk-based capital ratio of 8.0% or greater, a Tier 1 risk-based capital ratio of 4.0% or greater, and a leverage ratio of 4.0% or greater and is not "well capitalized"; (iii) "undercapitalized" if the institution has a total risk-based ratio that is less than 8.0%, a Tier 1 risk-based capital ratio of less than 4.0% or a leverage ratio of less than 4.0%; (iv) "significantly undercapitalized" if the institution has a total risk-based capital ratio of less than 6.0%, a Tier 1 risk-based capital ratio of less than 3.0% or a leverage ratio of less than 3.0%; and (v) "critically undercapitalized" if the institution's tangible equity is equal to or less than 2.0% of average quarterly tangible assets. An institution may be downgraded to, or deemed to be in, a capital category that is lower than that indicated by its capital ratios if it is determined to be in an unsafe or unsound condition or if it receives an unsatisfactory examination rating with respect to certain matters. As of December 31, 2008, the Company and the bank were "well capitalized," based on the ratios and guidelines described above. A bank's capital category is determined solely for the purpose of applying prompt corrective action regulations, and the capital category may not constitute an accurate representation of the bank's overall financial condition or prospects for other purposes.

The FDIA generally prohibits a depository institution from making any capital distributions (including payment of a dividend) or paying any management fee to its parent holding company if the depository institution would thereafter be undercapitalized. Undercapitalized institutions are subject to growth limitations and are required to submit a capital restoration plan. The agencies may not accept such a plan without determining, among other things, that the plan is based on realistic assumptions and is likely to succeed in restoring the depository institution's capital. In addition, for a capital restoration plan to be acceptable, the depository institution's parent holding company must guarantee that the institution will comply with such a capital restoration plan. The aggregate liability of the parent holding company is limited to the lesser of (i) an amount equal to 5.0% of the depository institution's total assets at the time it became undercapitalized and (ii) the amount which is necessary (or would have been necessary) to bring the institution into compliance with all capital standards applicable with respect to such institution as of the time it fails to comply with the plan. If a depository institution fails to submit an acceptable plan, it is treated as if it is "significantly undercapitalized."

"Significantly undercapitalized" depository institutions may be subject to a number of requirements and restrictions, including orders to sell sufficient voting stock to become "adequately capitalized," requirements to reduce total assets, and cessation of receipt of deposits from correspondent banks. "Critically undercapitalized" institutions are subject to the appointment of a receiver or conservator.

The federal regulatory authorities' risk-based capital guidelines are based upon the 1988 capital accord of the Basel Committee on Banking Supervision (the "BIS"). The BIS is a committee of central banks and bank supervisors/regulators from the major industrialized countries that develops broad policy guidelines for use by each country's supervisors in determining the supervisory policies that apply. In 2004, the BIS published a new capital accord to replace its 1988 capital accord, with an update in November 2005 ("BIS II"). BIS II provides two approaches for setting capital standards for credit-risk—an internal ratings-based approach tailored to individual institutions' circumstances (which for many asset classes is itself broken into a "foundation" approach and an "advances or A-IRB" approach, the availability of which is subject to additional restrictions) and a standardized approach that bases risk weightings on external credit assessments to a much greater extent than permitted in existing risk-based capital guidelines. BIS II also would set capital requirements for operational risk and refine the existing requirements for market risk exposures.

The U.S. banking and thrift agencies are developing proposed revisions to their existing capital adequacy regulations and standards based on BIS II. In November 2007, the agencies adopted a definitive final rule for implementing BIS II in the United States that would apply only to internationally active banking organizations, or "core banks"—defined as those with consolidated total assets of $250 billion or more or consolidated on-balance-sheet foreign exposures of $10 billion or more. The final rule became effective as of April 1, 2008. Other U.S. banking organizations may elect to adopt the

requirements of this rule (if they meet applicable qualification requirements), but they will not be required to apply them. The rule also allows a banking organization's primary federal supervisor to determine that the application of the rule would not be appropriate in light of the bank's asset size, level of complexity, risk profile, or scope of operations. In July 2008, the agencies issued a proposed rule that would adopt the standardized approach of BIS II for credit risk, the basic indicator approach of BIS II for operational risk, and related disclosure requirements. While this proposed rule generally parallels the relevant approaches under BIS II, it diverges where United States markets have unique characteristics and risk profiles, most notably with respect to risk weighting residential mortgage exposures. Comments on the proposed rule were due to the agencies by October 27, 2008, but a definitive final rule has not been issued. The proposed rule, if adopted, would replace the agencies' earlier proposed amendments to existing risk-based capital guidelines to make them more risk sensitive (formerly referred to as the "BIS I-A" approach).

The Company is not required to comply with BIS II and has made a determination not to apply the BIS II requirements.

Support of the Bank

The Federal Reserve Board has stated that a bank holding company should serve as a source of financial and managerial strength to its subsidiary banks. As a result, the Federal Reserve Board may require the parent company to stand ready to use its resources to provide adequate capital funds to its banking subsidiaries during periods of financial stress or adversity. This support may be required at times by the Federal Reserve Board even though not expressly required by regulation and even though the parent company may not be in a financial position to provide such support. In addition, any capital loans by a bank holding company to any of its subsidiary banks are subordinate in right of payment to deposits and to certain other indebtedness of such subsidiary banks. The BHCA provides that, in the event of a bank holding company's bankruptcy, any commitment by the bank holding company to a federal bank regulatory agency to maintain the capital of a subsidiary bank will be assumed by the bankruptcy trustee and entitled to priority of payment. Furthermore, under the National Bank Act, if the capital stock of the bank is impaired by losses or otherwise, the OCC is authorized to require payment of the deficiency by assessment upon the parent company. If the assessment is not paid within three months, the OCC could order a sale of the capital stock of the bank held by the parent company to make good the deficiency.

FDIC Insurance

The FDIC utilizes a risk-based assessment system that imposes insurance premiums based upon a risk matrix that takes into account a bank's capital level and supervisory rating. As of January 1, 2007, the previous nine risk categories utilized in the risk matrix were condensed into four risk categories which continue to be distinguished by capital levels and supervisory ratings.

The three capital categories are "well capitalized," "adequately capitalized," and "undercapitalized." These three categories are substantially the same as the prompt corrective action categories previously described, with the "undercapitalized" category including institutions that are "undercapitalized," "significantly undercapitalized," and "critically undercapitalized" for prompt corrective action purposes.

Under the Federal Deposit Insurance Reform Act of 2005, which became law in 2006, the bank received a one-time assessment credit that can be applied against future premiums through 2010, subject to certain limitations. Any increase in insurance assessments could have an adverse impact on the earnings of insured institutions, including the bank. The bank paid a deposit insurance premium in 2008 amounting to $710,267 which was net of a remaining available credit of approximately $110,000. As of December 31, 2008, there was no credit available to offset future deposit insurance assessments.

In addition, the bank is required to make payments for the servicing of obligations of the Financing Corporation ("FICO") issued in connection with the resolution of savings and loan associations, so long as such obligations remain outstanding. The bank paid a FICO assessment in 2008 amounting to $167,827. The FICO annualized assessment rate for the first quarter of 2009 is 1.14 cents per $100 of deposits.

The enactment of Emergency Economic Stabilization Act of 2008 ("EESA") temporarily raised the basic limit on federal deposit insurance coverage from $100,000 to $250,000 per depositor. The temporary increase in deposit insurance coverage became effective on October 3, 2008. EESA provides that the basic deposit insurance limit will return to $100,000 after December 31, 2009.

On November 21, 2008, the Board of Directors of the FDIC adopted a final rule relating to the Temporary Liquidity Guarantee Program ("TLG Program"). The TLG Program was announced by the FDIC on October 14, 2008, preceded by the determination of systemic risk by the Secretary of the Department of Treasury (after consultation with the President), as an initiative to counter the system-wide crisis in the nation's financial sector. Under the TLG Program the FDIC will (i) guarantee, through the earlier of maturity or June 30, 2012, certain newly issued senior unsecured debt issued by participating institutions on or after October 14, 2008, and before June 30, 2009 and (ii) provide full FDIC

deposit insurance coverage for non-interest bearing transaction deposit accounts, Negotiable Order of Withdrawal (“NOW”) accounts paying less than 0.5% interest per annum and Interest on Lawyers Trust Accounts held at participating FDIC-insured institutions through December 31, 2009. Coverage under the TLG Program was available for the first 30 days without charge. The fee assessment for coverage of senior unsecured debt ranges from 50 basis points to 100 basis points per annum, depending on the initial maturity of the debt. The fee assessment for deposit insurance coverage is 10 basis points per annum on amounts in covered accounts exceeding $250,000 payable quarterly. On December 5, 2008, the bank elected to participate in the deposit insurance program and declined, along with the parent company, to participate in the debt guarantee program.

On February 27, 2009, the Board of Directors of the FDIC adopted a final rule relating to a restoration plan designed to replenish the Deposit Insurance Fund over a period of five years and to increase the deposit insurance reserve ratio, which decreased to 0.40% (preliminary) of insured deposits on December 31, 2008, to the statutory minimum of 1.15% of insured deposits by December 31, 2013. In order to implement the restoration plan, the FDIC changed both its risk-based assessment system and its base assessment rates. For the first quarter of 2009 only, the FDIC increased all FDIC deposit assessment rates by 7 basis points. These new rates range from 12-14 basis points for Risk Category I institutions to 50 basis points for Risk Category IV institutions. Beginning April 1, 2009, the base assessment rates would range from 12-16 basis points for Risk Category I institutions to 45 basis points for Risk Category IV institutions. In addition, on February 27, 2009, the FDIC adopted an interim rule that imposes an emergency special assessment rate of 20 basis points based on June 30, 2009 deposits, payable by all insured depository institutions on September 30, 2009, in addition to the base assessment rate changes described above. The FDIC may impose additional special assessment of up to 10 basis points thereafter if the deposit insurance reserve ratio falls. Changes to the risk-based assessment system includes increasing premiums for excessive use of secured liabilities, including Federal Home Loan Bank advances, lowering premiums for smaller institutions with very high capital levels, and adding financial ratios and debt issuer ratings to the premium calculations for banks with over $10 billion in assets, while providing a reduction for their unsecured debt. Either an increase in the Risk Category of the bank or adjustments to the base assessment rates could have a material adverse effect on our earnings.

Under the FDIA, insurance of deposits may be terminated by the FDIC upon a finding that the institution has engaged in unsafe and unsound practices, is in an unsafe or unsound condition to continue operations, or has violated any applicable law, regulation, rule, order, or condition imposed by the FDIC.

In its resolution of the problems of an insured depository institution in default or in danger of default, the FDIC is generally required to satisfy its obligations to insured depositors at the least possible cost to the deposit insurance fund. In addition, the FDIC may not take any action that would have the effect of increasing the losses to the deposit insurance fund by protecting depositors for more than the insured portion of deposits or creditors other than depositors.

Emergency Economic Stabilization Act of 2008

In response to recent unprecedented market turmoil, the Emergency Economic Stabilization Act of 2008 was enacted on October 3, 2008. EESA authorizes the U.S. Department of Treasury (the “Treasury”) to provide up to $700 billion for the financial services industry. Pursuant to the EESA, the Treasury was initially authorized to use $350 billion for the Troubled Asset Relief Program (“TARP”). Of this amount, Treasury allocated $250 billion to the TARP Capital Purchase Program. On January 15, 2009, the second $350 billion of TARP monies was released to the Treasury. The Secretary’s authority under TARP expires on December 31, 2009, unless the Secretary certifies to Congress that extension is necessary provided that his authority may not extend beyond October 3, 2010.

Pursuant to authority under EESA, the Treasury created the TARP Capital Purchase Program under which the Treasury will invest up to $250 billion in senior preferred stock of U.S. banks and savings associations or their holding companies. Qualifying financial institutions may issue senior preferred stock with a value equal to not less than 1% of risk-weighted assets and not more than the lesser of $25 billion or 3% of risk-weighted assets. The preferred stock will pay dividends at the rate of 5% per annum until the fifth anniversary of the investment and thereafter at the rate of 9% per annum. The senior preferred stock may not be redeemed for three years except with the proceeds from an offering of common stock or preferred stock qualifying as Tier 1 capital in an amount equal to not less than 25% of the amount of the senior preferred. After three years, the senior preferred may be redeemed at any time in whole or in part by the financial institution. No dividends may be paid on common stock unless dividends have been paid on the senior preferred stock. Until the third anniversary of the issuance of the senior preferred, the consent of the Treasury will be required for any increase in the dividends on common stock or for any stock repurchases unless the senior preferred has been redeemed in its entirety or the Treasury has transferred the senior preferred to third parties. The senior preferred will not have voting rights other than the right to vote as a class on the issuance of any

preferred stock ranking senior, any change in its terms or any merger, exchange or similar transaction that would adversely affect its rights. The senior preferred will also have the right to elect two directors if dividends have not been paid for six periods. The senior preferred will be freely transferable and participating institutions will be required to file a shelf registration statement covering the senior preferred. The issuing institution must grant the Treasury piggyback registration rights. Prior to issuance, the financial institution and its senior executive officers must modify or terminate all benefit plans and arrangements to comply with EESA. Senior executives must also waive any claims against the Department of Treasury.

In connection with the issuance of the senior preferred, participating institutions must issue to the Treasury immediately exercisable 10-year warrants to purchase common stock with an aggregate market price equal to 15% of the amount of senior preferred. The exercise price of the warrants will equal the market price of the common stock on the date of the investment. The Treasury may only exercise or transfer one-half of the warrants prior to the earlier of December 31, 2009 or the date the issuing financial institution has received proceeds equal to the senior preferred investment from one or more offerings of common or preferred stock qualifying as Tier 1 capital. The Treasury will not exercise voting rights with respect to any shares of common stock acquired through exercise of the warrants. The financial institution must file a shelf registration statement covering the warrants and underlying common stock as soon as practicable after issuance and grant piggyback registration rights. The number of warrants will be reduced by one-half if the financial institution raises capital equal to the amount of the senior preferred through one or more offerings of common stock or preferred stock qualifying as Tier 1 capital.

On December 23, 2008, the Company issued preferred shares and a warrant to purchase its common shares to the Treasury as a participant in the TARP Capital Purchase Program. The amount of capital raised in that transaction was $42,000,000, approximately three percent of the Company’s risk-weighted assets. Prior to December 23, 2011, unless we have redeemed all such preferred shares or the Treasury has transferred all such preferred shares to a third party, the consent of the Treasury will be required for us to, among other things, increase the dividend on our common shares above the current quarterly cash dividend of $0.19 per share or repurchase our common shares or outstanding preferred shares except in limited circumstances.

In addition, until the Treasury ceases to own any of the Company’s securities sold under the TARP Capital Purchase Program, the compensation arrangements for our senior executive officers must comply in all respects with EESA and the rules and regulations there under. In compliance with such requirements, each of our senior executive officers in December 2008 agreed in writing to accept the compensation standards in existence at that time under the TARP Capital Purchase Program and thereby cap or eliminate some of their contractual or legal rights. The provisions agreed to were as follows:

- No Golden Parachute Payments. “Golden parachute payment” under the TARP Capital Purchase Program means a severance payment resulting from involuntary termination of employment, or from bankruptcy of the employer, that exceeds three times the terminated employee’s average base salary over the five years prior to termination. Our senior executive officers have agreed to forgo all golden parachute payments for as long as two conditions remain true: They remain “senior executive officers” (CEO, CFO and the next three highest-paid executive officers), and the Treasury continues to hold our equity securities we issued to it under the TARP Capital Purchase Program (the period during which the Treasury holds those securities is the “CPP Covered Period.”).

- Recovery of Bonus and Incentive Compensation if Based on Certain Material Inaccuracies. Our senior executive officers have also agreed to a “clawback provision,” which means that we can recover incentive compensation paid during the CPP Covered Period that is later found to have been based on materially inaccurate financial statements or other materially inaccurate measurements of performance.

- No Compensation Arrangements That Encourage Excessive Risks. During the CPP Covered Period, we are not allowed to enter into or maintain compensation arrangements that encourage senior executive officers to take “unnecessary and excessive risks that threaten the value” of the Company. To make sure this does not happen, our Compensation Committee is required to meet at least once a year with our senior risk officer to review our executive compensation arrangements in the light of our risk management policies and practices. Our senior risk officer will, if required to, review our executive compensation arrangements in light of our risk management policies and practices. Our senior executive officers’ written agreements include their obligation to execute whatever documents we may require in order to make any changes in compensation arrangements resulting from the Compensation Committee’s review.

- Limit on Federal Income Tax Deductions. During the CPP Covered Period, we are not allowed to take federal income tax deductions for compensation paid to senior executive officers i