



## Stonebridge Financial Corp.

March 9, 2009

Special Inspector General – TARP  
1500 Pennsylvania Avenue, NW  
Suite 1064  
Washington, D.C. 20220

Dear Special Inspector General:

Pursuant to your letter dated February 6, 2009, please accept this response to your request for information. Stonebridge Financial Corp. intends to fully comply with the terms of our agreement to accept and use the TARP funds and as such I have divided our response into two sections dealing with use of the funds and executive compensation.

In addition to this direct response to you, I have taken the liberty of copying the FDIC, **(b) (6)** Stonebridge Financial Corp. is the holding company for Stonebridge Bank which is its sole banking subsidiary comprising virtually all of its assets. Stonebridge Bank is a Pennsylvania state-chartered nonmember institution and, as such, is subject to FDIC rules and regulations, including its recent pronouncement, FIL-1-2009. As such, we will implement a process to monitor our use of capital injections, liquidity support and/or financing guarantees obtained through recent financial stability programs established by Department of the Treasury, the FDIC and the Federal Reserve. In particular, the monitoring processes should help to determine how participation in these federal programs has assisted Stonebridge Bank in supporting prudent lending and/or supporting efforts to work with existing borrowers to avoid unnecessary foreclosures for residential mortgage loans.

Our Press Release announcing receipt of the TARP funds and the potential uses is attached.

### **USE OF FUNDS:**

Stonebridge Financial Corp. applied for \$10,973,000 in TARP funds on October 29, 2008. These funds were received on January 23, 2009.

The original intention in applying for these funds was, in part, to provide capital to replace losses that occurred in June due to our loss on private label mortgage backed bonds held through the Shay Mutual Fund, but mostly to provide additional capital to allow our company to continue to make loans and grow deposits in our community.

Based on the loss in the mutual fund and to continue to remain well-capitalized, Stonebridge Financial Corp. borrowed \$2.0 million on a short-term basis and infused these funds into the capital of Stonebridge Bank. (I have enclosed a copy of our Press Release from June explaining this loss in more detail.)

Stonebridge Financial Corp.'s original plans in 2008 called for continued growth in assets, loans and deposits. To fund and capitalize this growth, the company had planned on raising capital in mid-2008 and commenced a rights offering to shareholders in the second quarter of 2008. Due to deteriorating market conditions, the rights offering was ineffective and, accordingly, this capital raising plan did not produce enough capital to support our planned growth.

Subsequent to the loss in June and our application for TARP funds, Stonebridge has been subjected to additional impairment losses due to private label mortgage backed securities that we received from the Shay Mutual Fund as a redemption in kind. Additionally, we felt it prudent to increase our loan loss allowance in the fourth quarter in recognition of future potential loan problems.

a) Anticipated use of TARP funds:

Stonebridge Financial Corp. will use the TARP funds in several ways. We have used \$2.0 million of these funds already to reduce our reliance on outside borrowings and strengthen the capital structure of Stonebridge Financial Corp. and Stonebridge Bank. We have taken an additional \$6.0 million in funds and invested these funds directly into Stonebridge Bank. We will further use these funds to strengthen the capital position of Stonebridge Bank as necessary, but the primary use of the TARP funds will be to make new loans and investments at Stonebridge Bank. It is our intention to invest the \$10,973,000 TARP funds directly and also leverage this investment by generating new deposits and growing assets by making new loans and investments.

Another purpose of the TARP funds is to try and develop programs to avoid residential mortgage foreclosures. Stonebridge Bank will follow FDIC guidance on this issue, but is proud of the fact that it has had very few residential mortgage foreclosures since its inception 10 years ago.

b) Segregation of TARP funds from other institutional funds:

Stonebridge Financial Corp. did not segregate TARP funds from other funding sources and capital when received on January 23, 2009.

c) Actual Use of TARP funds to date:

Stonebridge Financial Corp. did not receive the funds until January 23, 2009. The only specific use of the TARP funds to date has been to replace the temporary short term borrowings at the holding company and add to the capital of Stonebridge Bank for a total of \$8,000,000.

d) Expected use of unspent TARP funds

Our intended plan for the unspent TARP funds is to make new investments and loans to credit worthy borrowers and expand the bank. Additionally, our business plan called for expansion which would require additional capital. We will use the TARP funds as the additional capital since the private equity markets have “dried up”.

#### **EXECUTIVE COMPENSATION PLANS:**

Subsequent to the date of your letter, the American Recovery and Reinvestment Act of 2009 (ARRA) was signed into law. As you are aware, the requirements of ARRA largely replace the executive compensation requirements previously imposed under Section 111 of the Emergency Economic Stabilization Act of 2008 (EESA) and previously issued guidance by Treasury. Thus, the specific plans set forth below are meant to comply with Section 111 of EESA, as amended by ARRA, and, to the extent necessary, will be amended to address any rules or regulations promulgated by Treasury thereunder.

In connection with Treasury’s investment pursuant to TARP Capital Purchase Program (“CPP”), Stonebridge Financial has entered into a letter agreement with the Treasury, which, among other things, states that the provisions of Section 111 of EESA, as amended by ARRA, will apply to Stonebridge Financial. In addition, Stonebridge Financial intends to obtain waivers, which are substantially similar to the waivers Stonebridge Financial delivered to Treasury pursuant to Section 1.2(d)(v) of the Securities Purchase Agreement, from those additional highly compensated employees whom Stonebridge Financial believes are required by ARRA or any rules or regulations thereunder.

In light of the prohibition on Stonebridge Financial paying or accruing any bonus, retention award, or incentive compensation to its most highly compensated employee during the period in which any obligation arising from Treasury’s investment pursuant to TARP CPP remains outstanding, Stonebridge Financial will replace the annual cash incentives payable to such employee during such period, if any, with long-term restricted stock grants. Such restricted stock grants: (1) will not fully vest until Stonebridge Financial satisfies its obligation arising from Treasury’s investment pursuant to TARP CPP; (2) will not have a value that is greater than one-third (1/3) of the total amount of annual compensation of such employee; and (3) will be subject to such other terms and conditions as the Secretary of the Treasury may determine is in the public interest.

Stonebridge Financial neither maintains nor has any present intention to adopt any nonqualified deferred compensation or defined benefit arrangements that may offset the limitations imposed by Section 111 of EESA, as amended by ARRA.

Stonebridge Financial intends to use its best efforts to enter into letter agreements with its senior executive officers and any additional highly compensated employees required by ARRA, which will amend all compensation, bonus, incentive and other benefit plans, arrangements, policies and agreements, whether or not in writing, to

comply with Section 111 of EESA, as amended by ARRA, in all respects, including, but not limited to:

- a prohibition on “golden parachute payments” to Stonebridge Financial’s senior executive officers and its next five most highly compensated employees;
- a requirement that Stonebridge Financial recover any bonus, retention award, or incentive compensation paid to Stonebridge Financial’s most highly compensated senior executive officers and any of its next 20 most highly compensated employees based on statements of earnings, revenues, gains, or other criteria that are later found to be materially inaccurate;
- a prohibition on any compensation plan that would encourage manipulation of the reported earnings of Stonebridge Financial to enhance the compensation of any of Stonebridge Financial’s employees;
- limits on compensation that exclude incentives for Stonebridge Financial’s senior executive officers to take unnecessary and excessive risks that threaten the value of Stonebridge Financial; and
- a prohibition of any luxury expenditures by any employee of Stonebridge Financial in excess or outside the scope of a company-wide policy regarding excessive or luxury expenditures adopted by the Board of Directors of Stonebridge Financial.

Stonebridge Financial also is ready to assist Treasury review of bonuses, retention awards, and other compensation paid to its senior executive officers and any of its next 20 most highly compensated employees in 2008 or 2009 in order for Treasury to determine whether such payments are inconsistent with the purposes of Section 111 of EESA, as amended by ARRA, or TARP, or are otherwise contrary to the public interest. If directed by Treasury, Stonebridge Financial undertakes to negotiate with any such employee identified by Treasury an appropriate reimbursement identified by Treasury with respect to such compensation or bonuses.

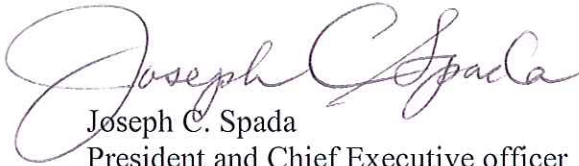
At its upcoming annual meeting of shareholders in 2009, Stonebridge Financial will be submitting a non-binding advisory proposal to its shareholders on its executive compensation. Such proposal is intended to comply with Section 111 of EESA, as amended by ARRA.

The Compensation Committee will review Stonebridge Financial’s executive compensation program to assess whether any aspect of the program would encourage any of Stonebridge Financial’s executives to take any unnecessary or excessive risks that could threaten the value of Stonebridge Financial and will meet with Stonebridge Financial’s risk official to better understand the material risks, including reputational risk, that Stonebridge Financial currently faces.

If you have any questions or concerns, feel free to contact me at (b) (6)

The undersigned duly authorized senior executive officer of Stonebridge Financial hereby certifies to the addressee, on behalf of Stonebridge Financial, that I have reviewed this response and supporting documents, and, based on my knowledge, this response and the supporting documents do not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading.

Sincerely,



Joseph C. Spada  
President and Chief Executive officer  
Stonebridge Financial Corp.  
Stonebridge Bank

(b) (6)

cc: (b) (8) FDIC

Enclosures: Press Release, Shay Mutual Fund  
Press Release, TARP Funding



**FOR IMMEDIATE RELEASE**

**CONTACT:**

Joseph C. Spada, Pres. & CEO 610-719-8221

[jspada@stonebridgebank.com](mailto:jspada@stonebridgebank.com)

**Stonebridge Financial Corp. to Recognize Second Quarter 2008 Impairment Charge for Investment in Shay AMF Ultra Short Mortgage Fund**

WEST CHESTER, Pa., July 3, 2008-- Stonebridge Financial Corp., the parent company of Stonebridge Bank, announced today that the Bank has terminated its investment in the Shay AMF Ultra Short Mortgage Fund (the "Fund") as of June 16, 2008 because of the continuing decline in the net asset value ("NAV") of the fund as well as the recent credit rating downgrade of certain non-agency private label mortgage backed securities held by the Fund. As a result of the NAV decrease, which was caused in large part by the uncertainty in spreads in the bond market for mortgage-related securities along with the performance of a small number of the bonds within the Fund, the Bank has determined that its investment in the Fund should be classified as other than temporarily impaired. Rather than continue as an investor in the Fund, the Bank elected to redeem its shares in the Fund and received a pro rata distribution of the securities held by the Fund on June 26, 2008. As a result, the Bank will incur an \$829,000 after tax charge, which includes a loss recognized as the fair value of the securities received being less than the carrying value of the mutual fund shares exchanged. The charge will be recognized for the quarter ended June 30, 2008, and Stonebridge expects that a substantial portion, but not all, of the charge will be offset by earnings for the quarter. A listing of the non-agency private label securities held in the Fund as of May 30, 2008 is available at <http://www.amffunds.com>.

The Bank will benefit from the receipt of the securities from the Fund by directly receiving all of the principal payments, including prepayments, made each month on the securities and will eliminate the 46 basis point fund management fees of approximately \$42,000 per year.

At June 16, 2008, prior to the redemption in kind, the Bank owned 967,037 shares of the Fund.

After giving effect to the charges relating to the redemption of its investment in the Fund, the Bank's capital ratios will continue to exceed the amounts necessary for the Bank to be considered well capitalized under applicable regulatory standards (5.00% for tier 1 leverage capital, 6.00% for tier 1 risk-based capital and 10.00% for total risk-based capital).

**About Stonebridge Financial Corp.**

The Company owns all the capital stock of the Bank. Stonebridge Bank is positioned as the Delaware Valley's Local Internet Bank™, combining community banking with advanced online technology. Based in West Chester, PA, Stonebridge Bank serves banking customers through its four full-service banking offices in West Chester, Exton, Warminster and Blue Bell, Pennsylvania, and a loan production office in Bel Air, MD. In addition, Stonebridge Bank offers customers around the nation a complete range of retail banking services through its website, <http://www.stonebridgebank.com>.

**Cautionary Statement**

This news release may contain “forward-looking statements” made pursuant to the safe harbor provisions of the Private Securities Litigation Act of 1995, such as statements of the Corporation’s goals, targets, plans, expectations, projections, estimates and intentions. Stonebridge Financial Corp. cautions potential investors that results and events subject to forward-looking statements could differ materially due to the following factors: possible changes in economic and business conditions, possible changes in monetary and fiscal policies, laws and regulations; possible changes in credit worthiness of customers and the possible impairment of loans; the effects of changing interest rates and other risks and factors.

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**FOR IMMEDIATE RELEASE**

CONTACT:

Susan H. Reeves, SVP 610-235-1505  
[sreeves@stonebridgebank.com](mailto:sreeves@stonebridgebank.com)

**Stonebridge Financial Corp. Receives \$10.97 Million Investment From the U.S. Treasury's Capital Purchase Program**

WEST CHESTER, Pa., January 26, 2009 -- Stonebridge Financial Corp., the parent company of Stonebridge Bank™, announced that it has received a \$10.97 million investment from the United States Department of Treasury under the Capital Purchase Program ("CPP"). The CPP is a voluntary program designed to provide capital to healthy, well managed financial institutions in order to increase the availability of credit to businesses and individuals and help stabilize the U.S. financial system. The \$10.97 million in Senior Preferred shares represents 3% of the Company's risk weighted assets as of September 30, 2008. The Company expects to utilize the majority of the funds to meet the credit needs of its customers and communities with some funds retained for general corporate purposes.

Joseph C. Spada, President & CEO, commented, "While the CPP is voluntary and these funds will further strengthen Stonebridge Bank's capital and liquidity position, I believe that our participation in the program will further enhance our ability to provide credit to businesses and consumers throughout the communities we serve during this time of financial uncertainty."

The Senior Preferred shares pay a dividend of 5% for each of the first five years of the investment and a 9% dividend thereafter, unless the Company redeems the shares. In conjunction with the purchase of the Senior Preferred shares, the U.S. Treasury received and exercised a Warrant to purchase \$549,000 of a separate class of Senior Preferred shares, at a nominal price. The Senior Preferred shares issued as a result of the Warrant pay a dividend of 9%.

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