ANNAPOLIS BANCORP INC.

March 6, 2009

Mr. Neil M. Barofsky
Office of the Special Inspector General
Troubled Asset Relief Program
1500 Pennsylvania Ave., N.W., Suite 1064
Washington, D.C. 20220

Dear Mr. Barofsky:

In response to your request dated February 6, 2009 related to Annapolis Bancorp, Inc.'s anticipated use of funds received through the Troubled Asset Relief Program ("TARP") and compliance with the executive compensation provisions of the Emergency Economic Stabilization Act of 2008 ("EESA") we provide the following:

Anticipated Use of TARP Funds

Annapolis Bancorp applied for TARP funds to strengthen its core capital reserves and facilitate additional lending by its bank subsidiary, BankAnnapolis (the "Bank"), in the communities it serves. *(See attached press release dated December 19, 2008.)* Annapolis Bancorp received TARP funds on January 30, 2009 and has transferred $8.152 million of such funds to the Bank. The TARP funds are being used for the above-stated purpose, but have not been segregated from other institutional funds. It is important to note that the Bank was well-capitalized before receiving the TARP funds and remains well-capitalized today with or without the TARP funds.

The additional core capital provided by TARP funds enabled the Bank to launch a major promotional campaign to raise deposits, the first step in leveraging its balance sheet to fund further loan growth. *(See attached "Superior Savings" brochure.)* Since Annapolis Bancorp received $8.152 million in TARP funds on January 30, 2009, the Bank has grown its total deposit base by $31.6 million or approximately ten percent (10%).

Although the recession has softened demand for credit on the part of small businesses and real estate developers and investors—the Bank's principal customer groups—the Bank is promoting the fact that it has money to lend to qualified borrowers *(see attached article from* The Capital *dated February 15, 2009)* and its business development and mortgage staffs are actively pursuing new lending opportunities to help stimulate local economic activity.

Compliance with Executive Compensation Requirements

Annapolis Bancorp is considered a "smaller reporting company" pursuant to Item 10 of Regulation S-K under the federal securities laws and as such must identify at least five senior executive officers

("SEOs") to comply with the rules set forth under the Capital Purchase Program ("CPP"), although only three are required for the disclosure pursuant to section 402 of Regulation S-K under federal securities laws. *(See attached 2008 summary compensation table for the SEOs.)* Annapolis Bancorp has identified those individuals and each signed the applicable executive compensation waivers required to close the TARP transaction on January 30, 2009.

In considering Annapolis Bancorp's compliance with the EESA requirements please note that Annapolis Bancorp does not directly employ any individual, all employees are employees of the Bank. The Compensation Committee which serves both Annapolis Bancorp and the Bank will certify compliance with the EESA provisions supported by the following:

- The Compensation Committee adopted a recapture policy effective for fiscal years ending after January 1, 2007 that established a claw-back policy providing for repayment of prior year bonuses and the forfeiture of any stock-based awards if an SEO's misconduct or fraud causes Annapolis Bancorp to restate past financial results. This policy is still in effect.

- No SEO has an employment agreement with the Bank that provides for golden parachute payments. Each SEO is subject to a change-in-control provision allowing for payment of one year's salary to the SEO in the event that such a change-in-control would result in the elimination of the SEO's position.

- No SEO is near or exceeds the $500,000 compensation level.

In the event that you have additional questions please contact Margaret Theiss Faison at [redacted]

I certify that the above information including all statements, representations and supporting documents are accurate as of the date indicated below, subject to the requirements and penalties set forth in Title 18, United States Code, Section 1001.

Richard M. Lerner
Chairman and Chief Executive Officer
Annapolis, Bancorp, Inc.

Date: 3/6/09

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Superior Savings from BankAnnapolis is now earning 4.22% APY* on every penny you put in. An offer to celebrate the opening of our **new Annapolis Towne Centre branch in Parole**. Just come in to any of our branches, open an account and start earning **over six times the average** local savings rate. **Interest earning deposit accounts are FDIC insured up to $250,000 per depositor.**

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Put in a penny. A buck. A zillion bucks. It's up to you.

No monthly fees.
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FDIC insured.
Safely and securely watch your money grow.

Flexible.
No need to tie up your funds for months at a time.

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Opening an account takes less time than a cup of coffee.

*APY means annual percentage yield. Introductory 4.22% APY based on interest rate of 4.13% and only available between 1/20/09 and 4/22/09. After 4/22/09, APY adjusts to the prevailing Superior Savings APY which is currently 2.50% based on interest rate of 2.47%. APY and interest rate become variable and may change at any time after 4/22/09 based on market conditions. Blended APY for the first year assuming funds on deposit from 1/20/09 is 2.94%. $25 fee if account is closed before 90 days. All deposits in a Superior Savings account must be funds not previously held at BankAnnapolis.

The Capital, 2/15/09

By Colleen Dugan — The Capital

BankAnnapolis CEO Richard Lerner and Kirk Spare, general manager at restaurant Gordon Biersch, one of the bank's customers, talk inside the new branch at Annapolis Towne Centre at Parole. BankAnnapolis received $8 million in federal TARP funds, but local bank officials say banks haven't been able to fully utilize the money because loan demand is so low.

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NOW WHAT?

With TARP money in hand, local bank officials say effort has fallen short

By KATIE ARCIERI
Staff Writer

Last year, the federal government issued banks billions of dollars in hopes of stabilizing the credit markets.

But at least two local institutions that received money from the U.S. Treasury Department's Troubled Asset Relief Program said the effort hasn't worked.

Executives from the locally owned BankAnnapolis and Severn Savings Bank said they are unable to fully use the TARP money for lending because loan demand is so low.

Richard Lerner, chairman and chief executive officer of BankAnnapolis, which received $8 million in federal funds, called the situation a Catch-22.

"I think there is a serious chicken-or-egg question that needs to be addressed," Lerner said. "Renewed lending follows the resurgence of economic activity and it doesn't create it."

Bank officials are having trouble with the widely criticized TARP program as the federal government rolls out even more initiatives to help lift the economy out of a recession.

Last week, Congress passed a compromise version of the $787 billion stimulus bill. President Barack Obama is expected to sign the bill early this week. The stimulus package is intended to create millions of jobs, invest in infrastructure, boost unemployment benefits, aid state governments and provide a variety of tax breaks.

On Tuesday, the Treasury Department unveiled a new financial stability plan that could commit more than $1 trillion in public and private support to help unfreeze the credit markets and relieve banks of toxic assets such as mortgage-backed securities.

Lakshman Achuthan, managing director of the Economic Cycle Research Institute in New York, said the new bailout program is a response that "more needs to be done" following TARP, which only addressed half of the nation's financial problems. While TARP kept the financial systems functioning, it didn't address loan demand from the private sector, he said.

"Most households are focusing a bit more on saving than borrowing," Achuthan said. "That is what your two banks are feeling. They are saying, 'I'm willing to lend but no one is borrowing.' It's normal, because we are in a recession."

Under the TARP program rolled out as part

(See BANKS, Page B4)

"You can only make the loans that someone wants. You can't force someone to borrow money."

— **Dan Nataf**, director of the Center for the Study of Local Issues at Anne Arundel Community College.

BANKS

(Continued from Page B1)

of a $700 billion economic stabilization plan last year, the federal government purchased preferred stock in banks to help them build capital and encourage lending. The initiative was quickly scrutinized by lawmakers and consumers alike.

Congressman John Sarbanes, D-Maryland, said in an interview that it was important to move forward on the TARP program last year. But the challenge was passing the measure with urgency while also providing sufficient oversight. He said lack of oversight led to TARP reform legislation that limited compensation for executives whose banks received assistance under the program.

"We can take a lesson that more transparency and more oversight is always helpful," said Sarbanes, who voted in favor of the stimulus package. "I think (U.S. Treasury Secretary Timothy) Geithner is in a position to insist on that now."

TARP problems

Banks are struggling with TARP for a variety of reasons that stem from the poor economy.

By Colleen Dugan — The Capital

Richard Lerner, chief executive officer of BankAnnapolis, stands in front of his bank's new branch at Annapolis Towne Centre at Parole.

Alan Hyatt, chairman and chief executive officer for Severn Savings Bank, which received $23.5 million in TARP funds, said his bank would like to generate at least $150 million in loans from the funds. But demand is weak.

"The overall economy is in bad shape, people are afraid to buy," Hyatt said. "They are not buying houses, they are not buying shoes, they are not going to nice restaurants. What we need in this economy is a boost of optimism."

Hyatt said both TARP and the government's new financial program do not address the problem of finding borrowers. "The public perception has to reach a point where the feeling is that real estate prices have more or less bottomed out," he said. "Until that happens, I don't think people are going to buy."

Joseph Cater, president of Market-Economics in Annapolis, said poor loan demand isn't the only reason banks are having problems with TARP. Consumers aren't able to meet stringent lending requirements, he said.

"If you don't have enough qualified borrowers, you're not going to have people purchasing homes," he said.

Dan Nataf, director of the Center for the Study of Local Issues at Anne Arundel Community College, said the rapid fall of the economy was not "widely anticipated" when TARP was first announced.

"You can only make the loans that someone wants," he said. "You can't force someone to borrow money."

He said President Barack Obama's economic stimulus package could generate more confidence in the economy, which should lead people to more loans. But consumer confidence is poor right now.

"It won't happen as long as people are seeing these job losses on the level that we're experiencing," he said.

And if poor loan demand continues, banks that participated in TARP may have to pay back dividends without making a profit, he said. Under TARP, bank shares purchased by the Treasury have a dividend rate of 5 percent per year. After five years, the dividend rates jump to a rate of 9 percent per year.

"It's like a double whammy," Nataf said.

Lending efforts

Fred Solomon, spokesman for PNC Financial Services Group, said the bank received its TARP funding at the end of the fourth quarter. Although it's too early to comment on the impact of loan demand just yet, the TARP funds increased PNC's capital and liquidity position, he said.

"PNC is healthy, solvent and ready to meet the credit and banking needs of its customers," he said.

Nick Lambrow, president of M&T Bank's Chesapeake Region, said the bank received the TARP funding and plans to use it for normal operating expenses. He said M&T is still growing from a loan standpoint, making 11 percent more loans in the fourth quarter compared with that period a year ago.

"We've always positioned ourselves to be a consistent and productive lender in the marketplace," Lambrow said.

Lerner of BankAnnapolis said his bank can easily lend the $8 million it received in TARP funds over a quarter or two. But the hope is to leverage those funds to generate anywhere from $75 million to $100 million in additional loans, he said. "That's going to depend on our ability to raise deposits," he said.

To boost lending, the bank is luring customers by reinstating its Superior Savings account last month with an introductory rate of 4.22 percent, he said.

After April 22, the annual yield adjusts to 2.25 percent, Lerner said. Lerner said customers have opened more than 500 new accounts in less than four weeks, helping the bank achieve 185 percent of its goal in deposit dollars. BankAnnapolis has a full business development staff trying to generate loans in the community, Lerner said.

"What stands in the way is this general perception that banks aren't lending," he said. "We are."

karciori@capitalgazette.com

Annapolis Bancorp, Inc.
SUMMARY COMPENSATION TABLE
Year-ended December 31, 2008

Name and Principal Position	Year	Salary $	Bonus $	Stock Awards $	Option Awards $	Non-equity Incentive Plan Compensation $	Change in pension volume and NQ DC Earnings $ *	All Other Compensation $ **	Total $
Richard Lerner Chief Executive Officer	2008	244,038	-				[redacted]	[redacted]	252,161
Margaret Theiss Faison Chief Financial Officer	2008	145,384	-				[redacted]	[redacted]	171,530
Ron Voigt Chief Business Development Officer	2008	145,384	-				[redacted]	[redacted]	152,094

[redacted]

* 401(k) match

** Imputed income on group term ligfe insurance and on bank-owned split dollar life insurance policies