



CONFIDENTIAL

March 4, 2009

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

Ladies and Gentlemen:

I am the President and Chief Executive Officer of Katahdin Bankshares Corp. (*KBS*) and of its wholly-owned subsidiary Katahdin Trust Company (the *Bank*). I am writing you in response to Mr. Barofsky's letter to me dated February 6, 2009.

Katahdin Trust Company was founded in 1918 and today continues to serve the needs of its customers, most of whom are in Northern Maine, a predominately rural area. The Bank has operated profitably for many years. In 2008 we suffered extraordinary losses from our investment in preferred stock of Fannie Mae and Freddie Mac (resulting in a pre-tax write-down of \$4,005,000), but still managed to earn \$2,013,000 in Net Profits for 2008, representing a 0.44% Return on Average Assets and 5.71% Return on Average Equity. *KBS* itself had Shareholders' Equity of \$35,636,000 at December 31, 2008, a 2.8% increase over the prior twelve months. Total Loans Outstanding at the end of 2008 reached \$357,233,000, an increase of 10.2% over 2007. In 2007, we posted \$4,251,000 in Net Profits, representing a 1.03% Return on Average Assets and 13.24% Return on Average Equity. Our Shareholders' Equity as of December 31, 2007 was 34.1% greater than at December 31, 2006, due in part to our having raised \$4,995,000 in additional capital through a private placement of common stock in March 2007. Total Loans Outstanding at the end of 2007 were 10.6% higher than at the end of 2006. Enclosed are audited year-end financial statements reflecting these results for 2008 and 2007.

As you know, on January 30, 2009 we consummated the sale of \$10,449,000 of preferred stock of *KBS* to the U.S. Treasury Department pursuant to Treasury's Capital Purchase Program (the *CPP*).

Use of CPP Funds

In response to Item 1 of your letter, we offer the following information.

The *KBS* Board of Directors decided in October 2008 to authorize management to apply to Treasury for inclusion in the *CPP*. At that time (and notwithstanding the substantial and unexpected write-down triggered when Fannie Mae and Freddie Mac were placed into conservatorship), *KBS* and the Bank exceeded all relevant regulatory thresholds for being "well capitalized" and fully expected to post significant Net Profits for the year. Consistent with Treasury's announced goals for the *CPP*, our principal motivation for seeking an infusion of additional capital under that program was to strengthen our balance sheet. Doing so, we concluded, would, *first and foremost*, help protect our ability to continue to provide much-needed banking services to customers in our rural territory, even if economic conditions in Maine were to decline very substantially, and, *secondarily*, provide additional resources to support continued expansion of our business

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and consumer lending activities assuming local conditions warrant doing so in a manner consistent with prudent banking standards.

(b) (4) (b) (4)

Following the recent CPP closing, KBS contributed the net proceeds of that transaction to the Bank as additional capital. The Bank holds and re-invests these funds in the same manner as, and does not attempt to segregate them from, other capital assets. Receipt of this incremental capital has not yet had any demonstrable effect on the Bank's lending activities or opportunities. Consistent with guidance from the Federal Deposit Insurance Corporation, management is working to design and implement appropriate procedures to monitor and document how participation in the CPP has assisted the Bank in supporting prudent lending and/or supporting efforts to work with existing borrowers to avoid unnecessary foreclosures. These procedures will include monitoring (by specific loan categories) of average aggregate monthly balances, new loans funded, and loans refinanced; we also will continue to track the level of our investments in various categories of mortgage backed securities.

Executive Compensation Practices

In response to Item 2 of your letter, we offer the following information.

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In preparation for the CPP transaction, KBS retained its outside counsel to review all of our compensation plans to determine whether these were in compliance with new rules implemented under the Emergency Economic Stabilization Act of 2008. Upon advice of counsel, we made minor amendments in certain plans, to assure that no combination (however unlikely) of severance-related payments could exceed applicable payment limits established under that Act, and to assure compliance with Section 409A of the Internal Revenue Code (relating to deferred compensation). These amendments are not expected to have any noticeable effect on compensation practices of KBS or the Bank, aside from assuring compliance with regulatory payment limits that in all likelihood would be met even without such amendments. To the extent that Treasury or other agencies impose additional restrictions on executive compensation, KBS and the Bank may be required to take additional steps to comply with such restrictions.

You have asked about loan risks and their relationship to executive compensation. (b) (4)

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(b) (4) KBS and the Bank do not anticipate difficulties in meeting any of the current CPP-related standards for executive pay.

Office of the Special Inspector General for
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March 4, 2009
Page 3

Supporting Statement

In signing this letter, I hereby certify, subject to 18 U.S.C. § 1001, that, as of the date hereof and to the best of my knowledge, the information set forth herein is accurate in all material respects and the enclosed audited financial statements fairly present, in all respects material hereto, the financial condition and results of operations of Katahdin Bankshares Corp.

Sincerely,



Jon J. Prescott
President and Chief Executive Officer

Enclosures

cc: Gregory S. Fryer, Esq.
Verrill Dana, LLP

2008 ANNUAL REPORT



See <http://www.katahdintrust.com/home/investor/annual> for the entire annual report.