

TOWNE BANK

March 4, 2009

Mr. Neil M. Barofsky
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 for information relating to our use of funds received under the Troubled Asset Relief Program and our compliance with EESA's executive compensation requirements, I submit for your review the following information.

- (1) TowneBank has taken the following actions regarding our TARP funds:
 - (a) In view of the uncertain economic environment, we initially accepted the TARP funds (\$76,458,000 through the Capital Purchase Program) to provide a significant additional cushion to keep our capital ratios at the "well-capitalized" level. It was a proactive decision to guard against unanticipated downturns in the credit quality of our loan portfolio.
 - (b) We did not segregate the TARP funds from our general operating funds, but instead began to immediately deploy them.
 - (c) We earmarked the TARP funds upon notification by the Treasury that we were approved. We were able to effectively deploy substantially all of the TARP funds back into the economy by lending it to local borrowers. We had loan growth of approximately \$79 million for the month of December and approximately \$150 million for the 4th quarter. Deposit growth for the 4th quarter was approximately \$40.3 million. Attached is certain supporting documentation describing our use of the TARP funds, as well as our latest earnings press release and a balance sheet at 9/30/08 compared to 12/31/08.
- (2) TowneBank's Compensation Committee met on February 27, 2009 and has reviewed the policies and incentive compensation programs for our senior executive officers, as required under the Capital Purchase Program, and the current guidance from the Treasury. The Compensation Committee has determined that:
 - (a) Due to the current limitations on executive compensation applicable to the senior executive officers under the Capital Purchase Program and

the ongoing economic uncertainty.

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To the extent TowneBank is permitted to pay any incentive compensation to the senior executive officers or other highly compensated employees under the guidelines to be issued by the Treasury under the American Recovery and Reinstatement Act of 2009, the Compensation Committee will review and consider later this year whether the payment or accrual of any incentive compensation is appropriate based on TowneBank's overall performance and other factors deemed relevant by the Compensation Committee.

- (b) Each of the five senior executive officers has agreed to the guidelines issued by the Treasury in connection with the Capital Purchase Program.
- (c) The Senior Risk Officer and the Compensation Committee are in the process of defining a Risk Assessment Checklist to be utilized on an ongoing basis whenever incentive compensation for senior executive officers is contemplated.
- (d) There are no plans at this time to offset such limitations by offering longer-term or deferred forms of executive compensation.

I, R. Scott Morgan, certify 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.



R. Scott Morgan.
President and Senior Lending Officer
TowneBank

TOWNE BANK

A Tradition of Hometown Banking.

News Release

FOR IMMEDIATE RELEASE

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TowneBank Reports 2008 Earnings of \$23.89 Million

2008 GROWTH RATES

	<u>Year Ended</u> <u>December 31, 2008</u>	<u>Increase Over Year</u> <u>Ended</u> <u>December 31, 2007</u>	<u>Growth Rate</u>
Assets	\$ 3.13 billion	\$ 632.50 million	25.29%
Loans	\$ 2.35 billion	\$ 520.73 million	28.46%
Deposits	\$ 2.24 billion	\$ 404.32 million	22.04%
Net Income	\$ 23.89 million	\$ 635 thousand	2.73%

Suffolk, Va. - Hampton Roads based TowneBank (NASDAQ: TOWN) reported net income of \$23.89 million for the year ended December 31, 2008 as compared to \$23.26 in 2007. This represented an increase of 2.73%.

Net interest income was \$87.13 million, an increase of \$1.63 million over last year. The increase in net interest income was attributed primarily to loan growth as the bank's interest margin declined to 3.50%, down from 3.94% in 2007. This decline in margin is a result of the rapid reduction in rates by the Federal Reserve system during 2008.

Non-interest income increased 11.31% to \$40.91 million. This increase can be partly attributed to the growth of the bank's property management business as total realty related revenue increased 14.05% to \$17.54 million. Insurance commissions also contributed significantly as revenue from the sale of

insurance products increased 6.39% to \$11.54 million.

Fully diluted earnings per common share decreased 3.26% to \$0.89 per share as compared to \$0.92 last year. This decrease was due to the company's first quarterly cash dividend on the \$59.85 million issue of 8% Non-Cumulative Convertible Preferred Stock, Series A purchased by investors during the third quarter of 2008.

Balance Sheet

Total bank assets reached a record level of \$3.13 billion, an increase of \$632.50 million over 2007. Towne's continuing commitment to meeting the credit needs of the community was demonstrated by loan growth of \$520.73 million, an increase of 28.46% over last year. Total deposits climbed to \$2.24 billion, representing a 22.04% increase over 2007.

Asset Quality

Asset quality remained excellent with total net loan losses of \$842 thousand representing a loss ratio of a modest 0.04%. Non-performing assets at December 31, 2008 totaled \$3.80 million or 0.12% of total assets as compared to 0.07% last year.

Due to the record loan growth, the bank's loan loss provision expense climbed to \$7.02 million, an increase of \$4.28 million. The bank's loan loss reserve remained unchanged at 1.17% of period end loans.

TARP

In December 2008, under the U. S. Treasury's TARP Capital Purchase Program, the bank issued to the U. S. Treasury 76,458 shares of Fixed Rate Non-Cumulative Perpetual Preferred Stock, Series B along with a ten year warrant to purchase 538,184 common shares at an exercise price of \$21.31 per share. This represented net new capital proceeds to the bank of \$76.46 million. Non-Cumulative dividends are payable at a rate of 5% annually over the first five years and a rate of 9% thereafter.

“As has been reported, the purpose of this program is to stimulate the economy and to make additional funds available to meet the credit needs of communities all across the nation,” said G. Robert Aston, Jr., Chairman and CEO. “I am pleased to report that during the fourth quarter we were able to increase our loan portfolio \$150.70 million that enabled us to fully lend our entire TARP proceeds to businesses, organizations, and consumers right here in Hampton Roads.”

Net income for the fourth quarter was \$5.45 million compared to \$5.87 million, a decrease of 7.19% from the comparable period of 2007. Earnings were negatively impacted by a \$1.66 million increase in the loan loss provision during the quarter as compared to the same period in 2007. The loan loss provision expense of \$2.49 million was necessitated by the sharp increase in loan volume, including the deployment of the TARP proceeds into new loans.

As one of Virginia’s top community banks, TowneBank now operates 17 banking offices in Chesapeake, Hampton, Portsmouth, Newport News, Virginia Beach, Norfolk, Williamsburg and York County. Towne also offers a full range of financial services through its controlled divisions and subsidiaries that include Towne Investment Group, Towne Insurance Agency, TFA Benefits, TowneBank Mortgage, TowneBank Commercial Mortgage, Prudential Towne Realty, TowneBank 1031 Exchange, LLC, Corolla Classic Vacations and Corolla Real Estate. Through its strategic partnership with William E. Wood and Associates, the bank also offers mortgage services in all of their offices in Hampton Roads and Northeastern North Carolina. Local decision-making is a hallmark of its hometown banking strategy that is delivered through the leadership of each group’s President and Board of Directors. With total assets of \$3.13 billion as of December 31, 2008, TowneBank is one of the largest banks headquartered in Virginia.

Forward-Looking Statements:

This release contains forward-looking statements as defined by the Private Securities Litigation Reform Act of 1995. These statements may address issues that involve significant risks, uncertainties, estimates and assumptions made by management. Factors that may cause actual results to differ materially from those contemplated by such forward-looking statements include competitive pressures in the banking industry that may increase significantly, changes in the interest rate environment may reduce margins and/or the volumes and values of loans made or held as well as the value of other financial assets held,

general economic conditions, either nationally or regionally, may be less favorable than expected, resulting in, among other things, a deterioration in credit quality and/or a reduced demand for credit or other services, changes in the legislative or regulatory environment, including changes in accounting standards, may adversely affect our businesses, costs or difficulties related to the integration of the business and the businesses we have acquired may be greater than expected, expected cost savings associated with pending or recently completed acquisitions may not be fully realized or realized within the expected time frame, our competitors may have greater financial resources and develop products that enable them to compete more successfully, changes in business conditions, changes in the securities market and changes in our local economy with regards to our market area and its heavy concentration of U.S. military bases and related personnel. We assume no obligation to update information contained in this release.

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ASSETS

	December 31, 2008	September 30, 2008	\$ Variance	% Variance
Cash and due from banks	\$ 67,280	\$ 218,197	\$ (150,917)	(69.2%)
Interest-bearing deposits in financial institutions	2,467	20,448	(17,981)	(87.9%)
Federal funds sold	20,000	30,000	(10,000)	(33.3%)
Total Cash and Cash Equivalents	<u>89,747</u>	<u>268,645</u>	(178,898)	(66.6%)
Securities available for sale, at fair value	347,740	212,109	135,631	63.9%
Securities held to maturity, at amortized cost	117,360	107,607	9,753	9.1%
Total Securities	<u>465,100</u>	<u>319,716</u>	145,384	45.5%
Mortgage loans held for sale	25,884	19,787	6,097	30.8%
Loans, net of unearned income	2,350,186	2,199,486	150,700	6.9%
Less: allowance for loan losses	(27,503)	(25,452)	(2,051)	8.1%
Net Loans	<u>2,322,683</u>	<u>2,174,034</u>	148,649	6.8%
Premises and equipment, net	78,991	78,907	84	0.1%
Goodwill	60,198	60,127	71	0.1%
Other intangibles	11,835	12,765	(930)	(7.3%)
Bank-owned life insurance policies	44,529	43,933	596	1.4%
Other assets	34,611	37,592	(2,981)	(7.9%)
TOTAL ASSETS	<u>\$ 3,133,578</u>	<u>\$ 3,015,506</u>	\$ 118,072	3.9%

LIABILITIES AND SHAREHOLDERS' EQUITY

Deposits:				
Noninterest-bearing demand	\$ 475,290	\$ 561,040	(85,750)	(15.3%)
Interest-bearing:				
Demand and money market accounts	489,485	503,982	(14,497)	(2.9%)
Savings	60,071	61,346	(1,275)	(2.1%)
Certificates of deposit:	1,213,822	1,071,992	141,830	13.2%
Total Deposits	<u>2,238,668</u>	<u>2,198,360</u>	40,308	1.8%
Advances from the Federal Home Loan Bank	363,877	363,886	(9)	(0.0%)
Convertible subordinated capital debentures	40,878	41,186	(308)	(0.7%)
Repurchase agreements and other borrowings	36,248	45,299	(9,051)	(20.0%)
Total Borrowings	<u>441,003</u>	<u>450,371</u>	(9,368)	(2.1%)
Other liabilities	34,237	33,403	834	2.5%
TOTAL LIABILITIES	<u>2,713,908</u>	<u>2,682,134</u>	31,774	1.2%
Preferred stock, \$5.00 par value				
Authorized shares - 2,000,000				
Issued and outstanding shares 669,650 in 2008	3,348	2,993	355	11.9%
Common stock, \$1.667 par value				
Authorized shares - 45,000,000				
Issued and outstanding shares 24,549,150 in 2008 and 24,104,418 in 2007	40,923	40,639	284	0.7%
Capital surplus	310,237	232,138	78,099	33.6%
Retained earnings	60,832	58,770	2,062	3.5%
Accumulated other comprehensive income	4,331	(1,168)	5,499	(470.8%)
TOTAL SHAREHOLDERS' EQUITY	<u>419,671</u>	<u>333,372</u>	86,299	25.9%
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	<u>\$ 3,133,578</u>	<u>\$ 3,015,506</u>	\$ 118,072	3.9%

INSIDE BUSINESS

Issue Date: Week of February 9 2009, Posted On: 2/6/2009

Area banks beef up loan loss reserves

MICHAEL SCHWARTZ - Staff Writer

Be prepared for the worst and show the public where the money is going. Those two courses of action seem to be the prevailing themes in the earnings reports released by local banks over the past couple of weeks.

Banks have proven in their fourth quarter and year-end financial reports that they are legitimately concerned about the potential for loan losses and rising delinquencies by noticeably increasing their provisions for loan losses, the amount of money set aside to cover for bad loans.

And some banks have also made it a point to prove to the public that they have used and are using TARP capital infusions, as intended, for lending to businesses and consumers.

Loan loss reserves increased dramatically across the board at the banks and bank-holding companies that have reported thus far.

First Bankshares, the holding company for SuffolkFirst Bank, increased its provision as of Dec. 31 to \$829,000, a 646.85 percent increase.

Old Point Financial Corp., parent of Old Point National Bank, increased its provision for loan losses by \$700,000 during the fourth quarter and by \$1.4 million for the year, leaving its reserve for loan losses at \$2.4 million.

Monarch's Financial Holdings, parent of Monarch Bank, recorded a loss for the fourth quarter and a 64 percent decrease in net income for the year due in part to increasing its loan loss reserves. Monarch increased its provision for loan losses by \$3.4 million in fourth quarter alone. As of the end of the year, its loan loss reserve stood at \$5.01 million, compared to less than \$1 million a year ago.

TowneBank increased its loan loss provision during the fourth quarter and for the year as a whole. Its provision for the fourth quarter was \$2.49 million, up from \$831,000 in the fourth quarter 2007. For the year, loan loss provision was \$7.02 million, up from \$2.74 million a year ago.

Heritage Bankshares and its subsidiary Heritage Bank, increased its provision for loan losses by \$385,000 during the fourth quarter and by more than \$350,000 for the year.

"Because of the deteriorating economic situation, we have been aggressive in our actions to deal with loan weaknesses as they arise," said Michael Ives, Heritage president and CEO, in the company earnings report. "We plan to continue our aggressive approach to identify asset quality issues as quickly as they arise and to act decisively to preserve the balance sheet of the bank."

Deciding how much to set aside for loan loss provisions isn't an exact science. While it counts against earnings, the reserves are still counted as capital. And if the loans don't go as bad as the reserves had been planned for, the capital is still there.

There are some rules of thumb but those tend to go out the window during times like these.

"When we made the estimate in October for the third quarter, things were very different," said Brad Schwartz, Monarch's CFO. "A lot has changed. More of our borrowers became a little more stressed."

Banks must find a balance to please both regulators and investors.

Regulators, Schwartz said, would love for banks to set aside more than enough. Whereas the stock market wants to see earnings, and loan loss reserve take a bit out of earnings.

But ultimately, it's an educated guess.

"It's an accounting estimate," Schwartz said. "You're looking into the future."

And the future isn't at all clear.

"We just basically said we don't know what the future holds," Schwartz said.

While loan losses try to predict the future, spreading the word about the use of TARP funds deals with present criticism.

Monarch made it a point to tell the world it had used all of the \$14.7 million it received in TARP capital for new loans.

"Many people think the government was giving a handout to banks," Schwartz said in Monarch's earnings report. "This is no handout. We will pay the taxpayers a dividend and warrants on this capital and use the funds to grow loans and help build our local economy. We remain committed to lending to our clients."

TowneBank included an entire section in its earnings release devoted specifically to TARP.

"I am pleased to report that during the fourth quarter we were able to increase our loan portfolio \$150.7 million that enabled us to fully lend our entire TARP proceeds to businesses,

organizations and consumers right here in Hampton Roads," said Towne CEO Bob Aston in the company's report.

Commonwealth Bankshares and Hampton Roads Bankshares have not yet released fourth-quarter and year-end earnings reports.

Commonwealth, parent of Bank of the Commonwealth, is trying to bounce back after having suffered unprecedented losses in the third quarter of 2008.

The company reported a loss of \$4.3 million for the nine months ended Sept. 30 and lost \$9.1 million in the third quarter. It increased its allowance for loan losses by \$19.0 million, up to a total of \$20.0 million for the third quarter.

HRB will file its year-end figures after having acquired two banks and their holding companies during the year. The company also was in the national spotlight recently after giving two of its executives big bonuses in the wake of it receiving \$80 million in TARP money.

INSIDE BUSINESS

Issue Date: Week of January 26 2009, Posted On: 1/23/2009

TowneBank takes piece of Prudential Realty

MICHAEL SCHWARTZ - Staff Writer

A day after the deal was inked, Barbara Wolcott was still getting used to the new name.

It took her a second to remember it's now Prudential Towne Realty.

"I'm enjoying saying it," said Wolcott.

Prudential Towne Realty is an entity created last week when Portsmouth-based TowneBank merged its GSH Real Estate subsidiary with Prudential Decker Realty of Virginia Beach and Prudential McCardle Realty of Williamsburg.

The deal was a couple of years in the making.

TowneBank first approach-ed the two Prudential franchises separately about two years ago to explore the idea of a buyout.

But the stakeholders, Wolcott and Jon and Trey Decker on the Prudential Decker side and Kimber and Randy Smith on the McCardle side, weren't interested.

Over time, the two real estate firms found they were operating more and more in each others' territories, Wolcott said, and discussions began about merging for "economies of scale and wider coverage."

Both sides also realized Towne was interested in each and it didn't hurt that Wolcott and Kimber Smith are TowneBank board members.

"We said why don't we talk to Towne and see if they would be interested in a merger," Wolcott said.

And so it came to be.

Towne, interested in expanding its presence in the real estate market after having acquired GSH Real Estate in 2004, wanted to continue building its one-stop-shop portfolio of subsidiaries.

"We got into the real estate business in order to, in effect, create a referral system that resonates throughout our organization," said Bob Aston, TowneBank's chairman and CEO.

TowneBank, through its various subsidiaries, can now sell someone a home, the mortgage for the purchase and homeowners insurance and it can conduct the closing.

"It's a great generator of new business all the way across," Aston said.

The two Prudential firms, known for selling higher-end properties, had the chance to align with a bank/financing arm known as a higher-end financial institution.

The fact that the real estate market is presently dicey didn't discourage Decker and McCardle from aligning itself with a bank that has a \$3 billion base of assets to back them up in tough times.

The deal also brings together GSH and Prudential, the former known for catering to real estate agents in the

early stages of their career and middle-income customers and the latter operating a tier above that.

Into history, however, goes the GSH name, which has been around since 1948. McCardle and Decker real estate firms have been a presence locally since the '60s and '70s respectively.

"It was not an easy decision to make to relinquish those names," Wolcott said.

Left in the wake is a company of which 65 percent is owned by TowneBank, with the remaining stake staying in the hands of the former Decker and McCardle owners.

Why didn't TowneBank go for a total acquisition of Decker and McCardle? The answer is that the Prudential parties didn't want to let go completely.

"Because we believe in what this is going to be," Wolcott said. "The more we got into it, we thought this is going to be huge and we want to be a part of it and we don't want to sell."

The specific financial details of the transactions will remain guarded.

Wolcott did say that Prudential Decker, being the larger of the two Prudential parties, will retain a larger share of the new entity than the McCardle side. And money was exchanged up front for Towne's 65 percent.

"We did put some cash into the deal," Aston said.

Aston said his company sees value in having part-owners who have a stake in both employment and equity.

Wolcott will be chairman and CEO of Prudential Towne. Kimber Smith will be president, Randy Smith will be senior vice president and Sandee Ferebee, the former president of GSH, will become chairman emeritus and serve on the company's board. Trey and Jon Decker will also be board members.

Prudential Towne will have an employee and agent base of about 600, after some consolidation in terms of both geographic operations and manpower that came as a result of the merger.

Agent turnover was expected from the outset, Wolcott said, both from more experienced agents and those who don't make a full career out of real estate.

The fact that Prudential Decker and McCardle were considered more "boutique-type operations," Wolcott said, merging with GSH, which is more recognized for bringing in entry-level agents, may not sit well with some.

The new company has no plans to move away from using entry-level agents or from catering to high-end customers, Wolcott said.

In fact the merger may help weed out those agents who entered the business during the real estate boom, trying to capitalize on selling a house to friends or relatives, but not having a long-term interest in the business.

"When you look at those people that you want in this business, you can't afford to have people that only want to siphon off a couple of transactions a year," Wolcott said.

Others may be turned off by the idea of a bank getting in bed with a real estate firm.

Up until 2003, banks could not own real estate agencies. However the Virginia Association of Realtors, along with the Virginia Bankers Association, helped introduce and push a bill through the General Assembly that allowed such relationships and ultimately paved the way for the TowneBank GSH deal in 2004.

"There are those realtors who believe banks should not be allowed in the business because it's unfair competition – which is garbage," Wolcott said.

However, plenty of real estate companies have their own financing arms and title companies.

"Turnabout is only fair play," Aston said.

Both sides believe this merger positions the combined entity to capitalize on the downturn of the market.

With TowneBank as its backing, the firm can look for possible acquisitions of troubled brokerages.

"There are some having to make very tough decisions," Wolcott said of other brokers. "We are in position to address those companies and grow our share of the market."

Aston said buying a stake of two real estate agencies during a downturn definitely was a better deal for his bank than it would have been four years ago.

"The timing was favorable to bring the deal together," he said.

And speaking of timing, some might wonder about the timing of the deal given that TowneBank just received \$76 million from the federal government through the TARP Capital Purchase Plan.

Did TowneBank use any TARP money for the deal?

"Not a chance of that," Aston said. "We got \$76 million. Our loans grew \$79 million in December. It is fully employed and out on the streets and then some. Anybody wants to know what we did with our money – it's cooked."