SOUTHERN ILLINOIS
BANCORP

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March 1, 2009

Mr. Neil M. Barofsky,
Special Inspector General - TARP
1500 Pennsylvania Avenue, NW, Suite 1064
Washington, D.C. 20220

Dear Mr. Barofsky:

This letter is the response for Southern Illinois Bancorp, Inc. to your letter dated February 6, 2009, requesting information regard our participation in the TARP – Capital Purchase Program.

1) Narrative Response Summarizing our Actions Regard TARP Capital Purchase Program

(a) Our anticipated use of TARP funds;

Southern Illinois Bancorp, Inc. and its subsidiary bank, The First National Bank of Carmi, Illinois, applied for participation in the TARP Capital Purchase Program on November 14th, 2008. At that time, we applied to participate in the program out of an abundance of caution. The news media and many economists were saying that this was going to be the worst recession since the Great Depression and the Federal Reserve Board and the U.S. Treasury Department were taking every imaginable step to stop the economy from sliding further. At that time, we were comfortable with our liquidity and asset quality assuming we had a moderately severe recession similar to the 1974-75 and 1982-84 recessions. However, we questioned whether our capital position was sufficient to handle a mild-depression.

Even though we did not think we would need the TARP funds, the bank's legal counsel suggested that we apply on the last day as an abundance of caution. The Treasury Department had indicated that they would process the application on a first filed first processed based and by applying on the last day we thought we would be one of the last applications processed. We did not anticipate hearing anything on our application until February or March. If the economy got worse and we needed the funds we would then be covered. If the recession was in line with our expectations, we could decline the funds at that time.

In late November 2008, Professional Bank Services (PBS) of Louisville, Kentucky completed our external loan review and confirmed our opinion on the quality of our loan portfolio. The lead examiner from PBS indicated that we had the cleanest loan portfolio he had seen in the past six months.

Much to our surprise we received a call from the Treasury Department on December 18, 2008, to inform us that we had been preliminarily approved to participate in the TARP Capital Purchase Program. This was 60 to 90 days earlier than we had anticipated having to make the decision on participating in the program.

Our first inclination was to decline to participation in the TARP - Capital Purchase Program. By this time, we had become comfortable with this being a severe recession and not a depression and that our capital base would be sufficient to carry us thru this difficult period of time. In addition, our external loan review had confirmed our opinion regarding our asset quality. We were confident that we could handle this recession on our own. However, we decided to discuss our participation with our external auditors and [redacted] (b) (8)

Our external auditors from Evansville, Indiana, encouraged us to participate in the program. They were not as confident about the economy as we were and even though we were a good bank, there is still a lot of uncertainty about the future direction of the economy. In addition, the problems some of our larger competitors were having had making it difficult for some of their customers to get their loans renewed on reasonable terms. Their opinion was that someone was going to need to step up and fill the void in the counties our bank serves in Indiana. While we may have sufficient capital to take care of our existing customers, we probably did not have enough capital to take care of our competitors customers.

Press coverage and talk within the industry on the severe loan problems both Fifth Third Bank and Integra Bank were having had already impacted our loan growth. During the last six months of 2008, we had experienced very strong loan growth. We were getting the opportunity to look at loans that normally would not consider our bank as a source of funding their operations.

The biggest problem we saw in participating in the program was doing so in a way that would not hurt our shareholders earnings. It would be impossible to loan the money out at rates high enough to cover the cost of preferred stock (over 9% on a pre-tax basis) without leveraging the funds. To breakeven on the transaction we would have to leverage the capital 2 to 1 with either FHLB borrowing or increased deposits.

At December 31, 2008, we transferred $700,000 to our allowance for loan losses due to changes in environmental factors. This transfer was not a transfer to cover specific losses on specific loans but was a reaction to the decline in the overall economy and not necessarily our loan portfolio. It was made as an abundance of caution.

At our January 19, 2009, meeting of the Board of Directors, we decided to go ahead and participate in the TARP Capital Purchase Program. ***The primary reason for our participation was that someone was going to need to fill the void left by Fifth Third Bank and Integra Bank in the two Indiana counties that we serve. If we were able to fill that void, it would positively impact our long term profitability even though it might hurt short term profitability. Participation would help our communities and hopefully would help us in the long term.***

Exhibit A attached, is a copy of our 5 year capital plan that relates to the use of TARP funds.

We are now reconsidering that decision. The strings being attached to those by the stimulus package and the mortgage provisions probably more than we are willing to accept. We are considering returning the money.

(b) Whether the TARP funds were segregated from other institutional funds;

Money is a commodity and segregating it would be very difficult if not impossible. In addition, if you strictly look at the TARP funds without leveraging those funds it is very unprofitable. ***Our response to this question would therefore be that we have not segregated the TARP funds from other institutional funds.*** [redacted] (b) (4)

(c) Our actual use of TARP funds to date;

To evaluate our use of the funds internally, we have made the assumption that we have $5 million in TARP and $10 million in leveraged funds or a total of $15 million to be used to grow our company. We have therefore made a simple distinction for the use TARP funds and the use of other funds. If a loan or municipal bond is to an existing customer of our bank it is considered to be funded by internally generated funds. If a loan is to an individual or company that is not currently a customer of our bank, we consider it to be funded by TARP funds. Excess funds are to be invested in mortgage backed securities issued by either FNMA or Freddie Mac.

We received the $5 million in TARP Capital Purchase Program funds on January 23, 2009.

When taking a global look at our loan portfolio, it appears that our lending has declined since December 31, 2008. However, this is normal seasonal fluctuation of our agricultural operating lines of credit. Our farmers normally sell their grain in January and February and pay down on their operating lines of credit. Our seasonal fluctuation is a low in March and a high in September or October for our grain farmers. When looking at loan grow in comparison to a year ago, our total loan portfolio has increased by $20 million. ***EXHIBIT B*** attached, shows the changes in our loan portfolio.

To date, we have closed one loan that meets the criteria we have set out for the use of TARP funds. In January 2009, Umbaugh (the municipal bonding agency for the State of Indiana) approached our bank about providing assistance to the City of Boonville, Indiana. Boonville is located in Warrick County which is adjacent to our market area. The City of Boonville Water & Sewer District needed to upgrade their water system and had already borrowed the legal lending limits at the two community banks in their town. The regional banks that also serve Warrick County had not bid on the project. They began to look outside their home market for assistance. We completed a $1,260,000 loan to them in January to assist their system upgrade. This is a loan we probably would not have made without the TARP funds.

Since receiving the TARP funds we have also acquired the following mortgage backed securities issued by Freddie Mac. These were new pools issued in September 2008 or January 2009.

Date Purchased	Bond Description	Maturity Date	Bond Equiv. Yield	Face Amount
1/26/2009	FHLMC Pool #1B3592 5/1 30 yr. ARM	9/1/2037	5.24%	1,359,723.26
1/26/2009	FHLMC Pool #1B4252 5/1 30 yr. ARM	9/1/2038	4.88%	2,462,015.95
2/18/2009	FHLMC Pool #FGG13408 15 yr.	1/1/2024	3.74%	2,431,916.05
2/18/2009	FHLMC Pool #FGJ09224 15 yr.	1/1/2024	3.89%	2,491,204.15
2/18/2009	FHLMC Pool #FGG18293 15 yr.	1/1/2024	3.87%	2,451,218.80

(d) Our expected use of unspent TARP funds;

We have also approved but not closed 3 other loans to individuals, not currently customers of our bank, which are located in an adjoining county with banks having liquidity problems. One of these loans is to a dentist wanting to refinance and remodel his office in Warrick County, Indiana ($800,000). A second loan is to a church that was asked to move their loan to their district financing to assist the bank with its liquidity problems in Vanderburgh County, Indiana ($1,200,000). The third is to a farm wanting to expand his operation that has out grown the legal lending limit of his current bank in Warrick County, Indiana($1,500,000). These 3 loans total $3.5 million.

In addition, we currently have $9 million in other loans to individuals not currently customers of our bank in underwriting review.

Attached as ***EXHIBIT C*** is a copy of a letter we ran in the local newspaper for the five counties we serve. This letter informed the public that we had accepted TARP funds and we were looking to make new loans. In addition, attached as ***EXHIBIT C*** is the follow up advertising we have done soliciting loans in the five county newspapers.

[redacted] (b) (4)

In all honesty, the brush we were painted with in Congressional hearings this past month has us reconsidering the use of the funds. All banks taking TARP funds were portrayed as being financially troubled banks and in need of the TARP money to survive. That is very obviously not the case in our situation. I have cleaned up two problem banks in my career and while not looking forward to doing so again, was willing to do so a third time. It is hard to motivate people to take actions for the well being of the communities we serve while they are being insulted in Congressional hearings.

It is our understanding that the Stimulus legislation will allow us to repay the money without issuing new capital and we are considering this course of action. Frankly, we do not need the grief.

2) Specific actions taken to address executive compensation requirements associated with the TARP funding.

The executive compensation provision of the TARP agreement have nearly no impact on the operations of our bank. The following summarizes the status of our compliance with those provisions.

(a) Identify the senior executive officers of the company.

The Senior Executive Officers for our company would be considered to be the following 4 individuals:

Alvin Fritschle, President & Chief Executive Officer
[redacted]ce President & Chief Financial Officer
[redacted]r. Vice President & Senior Loan officer
[redacted] Sr. Vice President – Relationship Banking in Indiana

(b) Incentive compensation of senior executive officers cannot encourage unnecessary risk.

[redacted]

There is no question this company place a high priority on asset quality in the review for these awards. This is reflected in the low level of criticized assets on the company's books.

(c) Bonuses and other incentive compensation paid to senior executive officers for periods during which the Treasury Department holds an equity or debt position acquired under the CPP must be subject to a "clawback" if payments were based upon materially inaccurate financial statements or any other materially inaccurate performance metric criteria.

These four individuals have signed agreements agreeing to the clawback provisions.

(d) Participating companies are prohibited from making any "golden parachute" payments to senior executive officers during the period Treasury holds and equity or debt position acquired under the Capital Purchase Plan.

No members of management have ever had a golden parachute.

(e) Participating companies agree as a condition to participating in the CPP, that no deduction will be claimed for income tax purposes for compensation in excess of $500,000 paid to a senior executive officer during any taxable year that the company participates in CPP.

[redacted] Therefore, this provision has no impact upon our bank.

<u>Certification of Senior Executive Officer</u>

I Alvin D. Fritschle, President and CEO of Southern Illinois Bancorp, Inc., herby certify to the accuracy of all statements, representations, and supporting information provided and that it is subject to the requirements and penalties set forth in Title 18, USC Section 1001.

Alvin D. Fritschle, President and CEO

3/5/2009
Date

Exhibit A

TARP Capital Purchase Plan

Explanation of the TARP Capital Purchase Program

The primary intent of the TARP Capital Purchase Program was to reduce the fear of a banking system collapse and to free up the credit markets that had virtually ground to a stop. Nearly all of the major banks had virtually stopped making loans because of uncertainty about the future. Many banks not only lost faith in their customer's ability to repay their loans, they questioned the ability of other banks to cover check clearing transactions. Fear had nearly paralyzed the entire banking system.

Following the lead of the European Union countries efforts to shore up their banking systems, the U.S. Treasury Department announce they would invest up to $250 billion of the TARP funds into healthy financial institutions as non-voting preferred stock last November.

- In order to build confidence in the banking system, eligible institutions were asked to sell an equity interest to the Treasury in amounts between 1% and 3% of the institutions risk-weighted assets. Some of the largest banks in the country were literally forced to take the money.
- The U.S. Treasury explicitly said that this was not a bail out for troubl[redacted] for healthy financial institutions to expand their lending activities. [redacted] In the long run it will save the government a substantial amount of money cleaning up the banking system.
- As a general rule, for every dollar of capital a bank has it has the ability to add $8 in loans assuming they can raise additional deposits and there are qualified businesses or individuals that want to borrow. Thus the $250 billion in additional capital in the banking system would support approximately $2 trillion in loans.

Summary of TARP Capital Purchase Plan

The U.S. Treasury Department will purchase perpetual preferred stock in a qualified financial institution of not less than 1% or more than 3% of the institutions risk-weighted assets. This preferred stock will be senior to common stock holders and equal to any other preferred stock previously issued by the financial institution.

In return for this investment the financial institution agrees to the following:

1. The preferred stock will pay a 5% cumulative dividend for the first five years and 9% thereafter.
2. Warrant equal to 5% of the investment will be issued to the U.S. Treasury Department to purchase additional preferred stock that carries a 9% dividend at $0.01 per share (1 share is $1,000.00). These preferred shares cannot be redeemed until all of the shares above are redeemed.
3. The preferred shares cannot be redeemed for 3 years from issuance date and it is anticipated that all stock is to be redeemed within 10 years.
4. For the first 3 years, the Treasury Department must approve any increases in common stock dividends. For years 3 thru 10, increases greater than 3% per year will require U.S. Treasury

Department approval, and after 10 years, the financial institution is prohibited from paying dividends until the stock is redeemed.

5. U.S. Treasury approved is required for the redemption of any common stock, preferred stock, or trust preferred obligations.
6. The compensation of the five most senior officers of the company is limited to no more than $500,000 per person per year.
7. The financial institution cannot make any golden parachute payments while the preferred stock is outstanding. A golden parachute payment is an amount greater than 3 times the employee's last year of compensation.

Southern Illinois Bancorp (First National Bank) TARP Decision

The senior management and the Board of Directors decided to participate in the program for the following reasons:

- First, we just do not know how bad the economy is going to get in 2009. Most economists are projecting 10% unemployment by the end of 2009. While our loan underwriting is conservative and strong, we will still feel the impact of a severe recession.
- Second, if we would have large loan losses from a severe recession and needed additional capital, it would be very difficult to obtain in today's market. Most banks are finding it nearly impossible to raise new capital. If we were unable to raise additional capital under these conditions, we might be put in the position of having to sell the bank under very unfavorable terms to our shareholders.
- Third, if we did have large loan losses due to the economy and we did not participate in the TARP program, the regulators will have little sympathy for us requesting capital in a weakened condition. In addition, the terms for banks obtain assistance outside of the Capital Purchase Program are finding the terms much stricter and more burdensome.
- [redacted] (b) (4)
- Fifth, while many in the general public consider this to be a bail out, the investment and financial services companies have a very different perception. The mid-sized and regional banks that have not obtained TARP funds are having their ability to survive questioned by their investors and suppliers. They perceive the fact that a bank has received TARP funds from the U.S. Treasury Department as a vote of confidence by the regulators in the management of the bank and the banks future.
- Finally, while we have sufficient capital to serve the credit needs of our existing customers, we do not have enough capital to handle the credit needs of our competitor's customers. It is very obvious that some of the banks we compete against are having severe financial problems. Their ability to survive this downturn is in question. They have nearly stopped making loans. Our accepting these TARP funds will allow us to help some of their customers remain in business. If we do not take care of these people, then who will?

We received preliminary approval from the Treasury Department on December 18, 2008 for a $5 million investment under the Capital Purchase Plan and received the formal approval letter on December 31, 2008. The transaction will have to be completed by January 30, 2009.

Date: 2/14/2009

Changes in Loans Report

Account Title	Current Balance	Balance Dec. 31, 2008	Current Year Change	Balance February 28, 2008	Balance Dec. 31, 2007	Prior Year Change	Year over Year Growth
99 **Total For All Centers**							
REAL ESTATE-LAND DEVELOPMENT	6,650,992	6,667,301	(16,309)	9,030,838	7,466,839	1,563,999	(2,379,846)
REAL ESTATE-FARMLAND	18,092,976	18,316,684	(223,709)	17,130,992	17,255,478	(124,486)	961,983
MORTGAGE LOANS HELD FOR SALE	970,199	190,973	779,226	32,736	305,289	(272,553)	937,463
REAL ESTATE-1-4 FAMILY RESIDENT	30,273,750	30,790,493	(516,743)	29,613,948	31,131,650	(1,517,702)	659,802
REAL ESTATE-MULTI-FAMILY RESIDI	2,983,043	3,003,931	(20,888)	2,695,698	2,715,157	(19,459)	287,345
REAL ESTATE-NONFARM NONRESID	26,272,780	25,784,397	488,383	20,366,323	19,743,491	622,831	5,906,458
AGRICULTURAL-PRODUCTION & EQ	7,376,814	22,710,133	(15,333,319)	16,056,165	19,465,839	(3,409,674)	(8,679,352)
AGRICULTURAL LINES OF CREDIT	10,234,016	0	10,234,016	0	0	0	10,234,016
COMMERCIAL LOANS	18,604,681	38,176,187	(19,571,505)	28,566,627	30,442,015	(1,875,387)	(9,961,946)
BUSINESS-COMMERCIAL LINES OF (	17,879,844	0	17,879,844	0	0	0	17,879,844
LETTERS OF CREDIT	0	0	0	0	0	0	0
CONSUMER LOANS	15,115,052	15,552,975	(437,924)	17,715,669	17,915,086	(199,417)	(2,600,618)
STATE AND POLITICAL SUB LOANS	5,224,104	3,993,835	1,230,270	1,397,369	1,398,567	(1,198)	3,826,736
LEASE FINANCING	6,649,996	6,714,076	(64,080)	1,071,026	862,073	208,954	5,578,970
CL - IN PROCESS	186,661	424,411	(237,751)	41,253	79,097	(37,844)	145,408
SERVICED LOANS IN PROCESS	0	0	0	(749)	(749)	0	749
LOAN PAYMENT SUSPENSE ACCT	(4,010)	(4,075)	65	(5,573)	(6,864)	1,291	1,563
INSURANCE IN PROCESS	1,387	5,305	(3,918)	(8,373)	1,186	(9,559)	9,760
HAZARD INSURANCE IN PROCESS	(593)	0	(593)	0	0	0	(593)
LOAN SERVICING CLEARING	1,348	0	1,348	0	0	0	1,348
SALES/REPURCHASE CLEARING	54,185	0	54,185	0	0	0	54,185
FASB 91 CAPITALIZED DEALER COS	71,757	71,741	16	75,339	76,526	(1,186)	(3,582)
FASB LEASED FINANCING	(2,953,668)	(2,962,174)	8,506	(242,723)	0	(242,723)	(2,710,945)
OVERDRAFTS	31,979	45,860	(13,881)	18,068	30,303	(12,235)	13,911
	163,717,293	169,482,054	(5,764,761)	143,554,634	148,880,982	(5,326,348)	20,162,659

Exhibit B

Exhibit C

An Open Letter to Our Customers and to the Communities We Serve
Regarding First Bank's Participation in the TARP Capital Purchase Program

Dear Taxpayers

Over the last several weeks, there has been a great deal of media coverage about the U.S. Treasury Department's Troubled Asset Relief Plan (TARP) and, in particular, the Capital Purchase Program for financial institutions. I would like to take this opportunity to explain the program and how Southern Illinois Bancorp and the First National Bank of Carmi (First Bank) have responded to it.

Explanation of the TARP Capital Purchase Program

The primary intent of the TARP Capital Purchase Program is to improve the strength of *healthy* financial institutions and to free up the credit markets that had virtually ground to a stop. Following the lead of the European Union countries' efforts to shore up their banking systems, the U.S. Treasury Department announced they would invest up to $250 billion of the TARP funds into *financially sound* institutions in the form of non-voting preferred stock last November.

The U.S. Treasury explicitly said that this was ***not a bail out for troubled institutions but a plan to assist healthy financial institutions to expand their lending activities***. As a general rule, for every dollar of capital a bank has, the bank has the ability to add $8 in loans, assuming they can raise additional deposits, and assuming there are qualified businesses or individuals who have the need to borrow. Thus, the $250 billion in additional capital in the banking system would support approximately $2 trillion in loans. This program would also provide additional capital for healthy banks to acquire problem banks that will need to be liquidated.

Unlike a subsidy that does not have to be repaid, all TARP investments in a bank must be repaid within 10 years, with interest. This is not a gift but a loan that qualifies as regulatory capital. The U.S. Treasury has the potential to make billions of dollars in profits from the dividends and warrants paid by the banks from this program and ultimately you the taxpayer will benefit.

Southern Illinois Bancorp (First Bank) TARP Decision

After much soul searching, the senior management and the Board of Directors of Southern Illinois Bancorp (First Bank) decided to participate in the TARP Capital Purchase Program, even though we were comfortable with our asset quality and our capital strength, for the following reasons:

- First, it is difficult to accurately forecast how much worse the economy will be in 2009. Many economists are projecting 10% unemployment by the end of 2009. While our loan underwriting is conservative and strong, we will still feel the impact of a severe recession. Should the recession be significantly worse than we anticipate, there would be a remote possibility that we would need additional capital.

- Second, many banks are finding it nearly impossible to raise new capital. If Southern Illinois Bancorp would need additional capital for the acquisition of another bank or if we experience exceptionally strong growth, we may not be able to raise the necessary capital.

- Third, while taxpayers may perceive this to be a bail out, the investment and financial services companies have a very different perception. Several mid-sized banks that have not been approved for TARP funds are now being penalized by their investors and suppliers. These companies perceive the fact that a bank has received TARP funds from the U.S. Treasury Department as a vote of confidence by the regulators in the management of the bank and the banks future.

- Finally, while Southern Illinois Bancorp (First Bank) has sufficient capital to serve the credit needs of our own customers, we may require additional capital to handle the credit needs of our competitors' customers. A few of our competitors are having their own financial challenges, and they have tightened their credit standards and restricted their lending. Our acceptance of TARP funds will allow us to increase our lending to credit-worthy businesses, agricultural producers, and consumers in the communities that we serve.

First Bank has money to lend

We completed the Capital Purchase Program transaction with the U.S. Treasury Department on January 23, 2009. It only took a few days for the U.S. Treasury Department to approve our application, while it is taking several months to decide if some of our competitors are healthy enough for an investment. The speed of our approval is directly associated with our financial strength, the integrity of our employees, and the quality of the customers we serve.

The investment by the U.S. Treasury Department in concert with very attractive deposit rates from the Federal Home Loan Bank and several million in new deposits during the month of January have provided us with substantial new money to invest into the communities we serve. While some banks have tightened their credit standards because of problem loans, First Bank continues to make loans to credit-worthy customers today as we have since 1893. Our total loan portfolio grew by over $20 million in 2008 and we are prepared for more growth in 2009. ***We are ready and willing to lend money in the communities we serve***.

I hope this letter has helped to clarify the intent and the prudent use of the funds that you, the taxpayer, have indirectly invested in our bank. We take this investment seriously and we will use the capital wisely to help finance the businesses and families in the communities we serve.

Very Respectfully,

Alvin Fritschle

Alvin Fritschle,
President & CEO

Member FDIC

Equal Housing Lender