

TRI-COUNTY FINANCIAL CORP.

Confidential Treatment Requested

March 5, 2009

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

Dear Mr. Barofsky:

On behalf of Tri-County Financial Corp. (the "Company"), I am responding to your request for information dated February 6, 2009. On December 19, 2008, the Company received \$15.5 million from the U.S. Department of the Treasury in the form of Preferred A shares. The Company and its operating subsidiary Community Bank of Tri-County (the "Bank") were above the "well-capitalized" level and were profitable prior to the receipt of these funds. The information below will illustrate how the funds received through the TARP Capital Purchase Program are being utilized to support the mission of the TARP program.

For your convenience, I have restated your questions, followed by our response.

Question 1:

Please provide a narrative response specifically outlining (a) your anticipated use of TARP funds; (b) whether the TARP funds were segregated from other institutional funds; (c) your actual use of TARP funds to date; and (d) your expected use of unspent TARP funds. In your response, please take into consideration your anticipated use of TARP funds at the time that you applied for such funds, or any actions that you have taken that you would not have been able to take absent the infusion of TARP funds.

Response:

(a) Neither the Company or the Bank made specific public statements regarding its intended use of TARP funds. In a press release issued on December 19, 2008, in connection with the closing of the transaction, the Company stated that participation in the TARP Capital Purchase Program will enable us to "enhance our already solid capital position and to pursue other growth opportunities in line with our strategic alternatives."

Further, an article published in the Maryland Independent on February 20, 2009, states that Michael L. Middleton, the President and Chief Executive Officer of the Company and the Bank “said that the bank is using the funds as ‘seed’ money and will leverage it to continue to grow its customer base while central banking markets continue to lock down.” Mr. Middleton also states in the article that “As a result of the CPP capital, the government receives its dividend, the market is served with new lending and the other shareholders benefit from growth.” Further, the article provides that “the money allows the bank to continue lending money, though like most others, it will be careful about to whom. [Mr. Middleton] said the funds will add value to common stock by using the money to invest in good assets.”

(b) The funds were segregated on the Company’s balance sheet from other capital received through their classification as preferred stock as opposed to common equity. As anticipated, these funds were then invested by the Company into the Bank. However, the cash was not segregated from other cash held at the Bank.

(c) The Company’s actual use of the TARP funds has been consistent with its public statements. On December 19, 2008, the Company invested all of the \$15.5 million in proceeds of the offering in the Bank as additional paid-in capital. This capital injection should allow the Bank to continue investing in loans and other assets at an amount well in excess of the funds injected. Since these funds are capital, the Bank, acting in a safe and sound manner and in accordance with applicable regulations, may increase total assets at a multiple of the funds received. For example, while maintaining a 10% capital ratio, the Bank has the ability to raise \$10 in deposits for every dollar of additional capital. These additional deposits will provide the funds to invest in loans or other interest earning assets. Therefore, the receipt of the \$15.5 million in TARP funds should enable us, over time, to increase loans or other assets by approximately \$155 million. As noted above, the Bank was above the level of “well-capitalized” prior to receiving TARP funds. However, the receipt of these funds increased our capital ratios thereby materially increasing the amount of loans and other interest earning assets that the Bank could add to its balance sheet.

Exhibit A illustrates the effect on the Bank’s capital ratios of the receipt of the TARP funds. At November 30, 2008, the Bank’s total risk-based capital ratio was 12.62%. As a result, the Bank could, without the CPP, grow its loan portfolio by an additional \$139 million to \$665 million, depending on the risk-weighting of the loans, without jeopardizing its “well-capitalized” level. As Exhibit A shows, the additional capital contributed to the Bank increased the Bank’s risk-based capital ratio to 14.81% as of January 31, 2009. With the additional \$15.5 million of capital, and the resulting improved capital ratios, the Bank gained the capacity to make an additional \$125 million of loans bringing the total available growth to \$264 million of loans, depending on the risk-weighting of the loans, while remaining well-capitalized.

As of January 31, 2009, the Company had already made significant strides towards deploying the capital provided by the TARP funds. Exhibit B illustrates the changes in the Bank’s balance sheet from November 30, 2008, which is before the closing of the

TARP transaction, to January 31, 2009, which is after the closing of the TARP transaction. As this exhibit illustrates, the Company's loan portfolio increased \$17.9 million, while investments increased by \$12.2 million. This increase was funded by the \$15.5 million in cash contributed to the Bank plus growth in deposits of approximately \$19.9 million. The Bank's primary activity is the origination of loans and the purchase of housing related securities for investment.

(d) As of January 31, 2009, 76.7% of the Bank's total assets were loans. We anticipate that the Bank will continue to leverage the capital provided by the TARP funds to make loans and grow its loan portfolio. We expect to continue to build our loan and investment portfolios going forward as we deploy the TARP funds. How quickly we can grow will be dependent on market conditions and our need to adhere to our conservative underwriting standards. These uses are consistent with the expectations for deployment when we first applied for TARP funds.

Question 2:

Your specific plans, and the status of implementation of those plans, for addressing executive compensation requirements associated with the funding. Information provided regarding executive compensation should also include any assessments made of loan risks and their relationship to executive compensation; how limitations on executive compensation will be implemented in line with Department of Treasury guidelines; and whether any such limitations may be offset by other changes to other, longer-term or deferred forms of executive compensation.

Response:

Section 1.2(d) (iv) of the Securities Purchase Agreement – Standard Terms provides that, as a condition to receiving TARP funds, the Company take any action necessary to change its compensation arrangements for senior executive officers in order to comply with Section 111(b) of EESA. In connection with receiving the TARP funds, the Company entered into an Acknowledgement and Agreement with each of its senior officers (a form of the agreement is attached as Exhibit C to this letter). The Acknowledgement and Agreement modifies all compensation arrangements applicable to the senior executive officers to comply with the Securities Purchase Agreement.

In addition, rules promulgated by the Treasury establish the certain standards applicable to participants in the TARP Capital Purchase Program. The Company has addressed each of these standards as follows:

(1) Review of SEO Compensation Arrangements by the Compensation Committee. No later than March 19, 2009, the Governance Committee (acting in a similar capacity as a compensation committee) of the Company will meet with the Company's senior risk officer to review the incentive compensation arrangements applicable to the senior executive officers. At this time, the Company has no reason to believe that its incentive

compensation arrangements encourage any senior executive officer to take unnecessary and excessive risks that threaten the value of the institution. The Company will continue this review process in the future as required by the Treasury and will make any necessary adjustments to its incentive compensation arrangements.

(2) Clawback of Incentive Compensation. By executing the Acknowledgement and Agreement, each of the Company's senior executive officers has agreed to a clawback of any bonus or other incentive compensation if the payment is based on materially inaccurate financial statements or any other materially inaccurate performance metric criteria.

(3) Prohibition on Golden Parachutes. By executing the Acknowledgement and Agreement, each of the Company's senior executive officers has agreed to a limitation on golden parachute payments.

(4) Deduction Limit on Executive Compensation. The Company has reviewed the overall compensation of its senior executive officers in order to determine the effect of Section 162(m)(5) of the Internal Revenue Code of 1986, as amended, regarding the \$500,000 deduction limit on compensation.

The American Recovery and Reinvestment Act of 2009 requires the Treasury to establish regulations to address further executive compensation restrictions contained in the Act. In accordance with information released by your office and absent more current guidance from the Treasury, our responses regarding executive compensation are submitted in accordance with the guidelines that are currently available from the Treasury.

* * * * *

The Company requests confidential treatment of this letter. The financial information contained in this letter and the exhibits hereto is financial information that is not otherwise available to the public and, therefore, is confidential. For this reason, this letter is protected under 5 U.S.C. § 552(b)(4).

* * * * *

The undersigned duly authorized senior executive officer of the Company hereby certifies, on behalf of the Company, and subject to the requirements and penalties set forth in Title 18, United States Code, Section 1001, that all statements, representations, and supporting information provided in and with this letter are true and complete to the best of my knowledge.

Sincerely,



Michael L. Middleton

Exhibit A

The following tables shows the Bank's actual capital ratios at November 30, 2008 and pro forma capital ratios after giving effect to the receipt of TARP funds.

Exhibit A

**Risk Based Capital
Community Bank of Tri County**

Risk Based Capital As Of November 30,2008

Risk Based Assets	531,414,507	
Risk Based Capital	67,042,141	
Risk Based Capital Required	53,141,451	10.00%
Risk Based Capital Actual	67,042,141	12.62%
Risk Based Capital Excess	13,900,690	2.62%

Additional assets available
assuming 100% risk weighting 139,006,903

Risk Based Capital as of January 31, 2009

Risk Based Assets	549,387,461	
Risk Based Capital	81,390,248	
Risk Based Capital Required	54,938,746	10.00%
Risk Based Capital Actual	81,390,248	14.81%
Risk Based Capital Excess	26,451,502	4.81%

Additional assets available
assuming 100% risk weighting 264,515,019

Increase in available asset
growth 125,508,116

Exhibit B

The table below illustrates the changes in the Company's balance sheet from November 30, 2008 to January 31, 2009. The Company received the TARP funds on December 19, 2008.

Exhibit B

Exhibit B
Community Bank of Tri County
Comparison of Balance Sheets

	<u>November</u>	<u>January</u>	<u>Dollar Change</u>
	<u>2008</u>	<u>2009</u>	
Cash	\$ 4,835,375	\$ 3,435,168	\$ (1,400,207)
Fed Funds	3,089,148	394,567	(2,694,581)
Interest Bearing Deposits	3,221,005	5,619,364	2,398,359
Money Market Funds	460,761	535,027	74,266
Investments Held to Maturity	95,306,391	107,112,003	11,805,612
Investments Available for sale	13,848,278	14,220,393	372,115
FHLB Fed Reserve Stock	6,248,300	6,227,200	(21,100)
Loans Net of Allowance	526,986,836	544,906,431	17,919,595
Foreclosed Real Estate	-	-	-
Premises Net	12,319,332	12,529,248	209,916
Accrued Interest	3,106,221	2,944,091	(162,130)
Investment in BOLI	10,491,572	10,561,119	69,547
Other Assets	<u>1,684,085</u>	<u>1,932,074</u>	<u>247,989</u>
	<u>\$ 681,597,304</u>	<u>\$ 710,416,685</u>	<u>\$ 28,819,381</u>
Liabilities			
Non-Interest Bearing Deposits	47,469,345	46,736,759	(732,586)
Interest Bearing Deposits	<u>459,987,366</u>	<u>480,578,411</u>	<u>20,591,045</u>
Total Deposits	507,456,711	527,315,170	19,858,459
Long term Borrowings	104,967,000	99,959,845	(5,007,155)
Short Term Borrowings	768,311	279,521	(488,790)
Accrued interest payable	2,700,279	2,121,268	(579,011)
Escrows for taxes and insurance	421,033	378,239	(42,794)
Other Liabilities	<u>3,817,664</u>	<u>3,903,211</u>	<u>85,547</u>
	<u>620,130,998</u>	<u>633,957,254</u>	<u>13,826,256</u>
Retained Earnings and Shareholders' Equity			
Common Stock	1,500,000	1,500,000	-
Capital Pd in Excess of Par	20,322,297	35,762,385	15,440,088
Retained Earnings	39,676,811	38,931,876	(744,935)
Valuation Allowance, net of tax	(32,802)	265,170	297,972
TOTAL CAPITAL	<u>61,466,306</u>	<u>76,459,431</u>	<u>14,993,125</u>
Total Liabilities & Equity	<u>\$ 681,597,304</u>	<u>\$ 710,416,685</u>	<u>\$ 28,819,381</u>

Exhibit B

Exhibit B

Tri- County Financial Corporation
Comparison of Balance Sheets

	<u>November</u> <u>2008</u>	<u>January</u> <u>2009</u>	<u>Dollar Change</u>
Cash and due from banks	\$ 4,835,375	\$ 3,435,168	\$ (1,400,207)
Federal funds sold	3,089,148	394,567	(2,694,581)
Interest-bearing deposits with banks	3,681,766	6,154,390	2,472,624
Securities available for sale	13,888,852	14,261,328	372,476
Securities held to maturity	95,306,391	107,112,003	11,805,612
FHLB and FReBank stock	6,248,300	6,227,200	(21,100)
Loans receivable	526,986,836	544,906,431	17,919,595
Premises and equipment, net	12,319,332	12,529,248	209,916
Foreclosed real estate	-	-	-
Accrued interest receivable	3,106,221	2,944,091	(162,130)
Investment in bank owned life insurance	10,491,572	10,561,119	69,547
Other assets	<u>3,679,242</u>	<u>4,167,555</u>	<u>488,313</u>
TOTAL ASSETS	<u>\$ 683,633,035</u>	<u>\$ 712,693,100</u>	<u>\$ 29,060,065</u>
LIABILITIES AND STOCKHOLDERS' EQUITY			
LIABILITIES:			
Noninterest-bearing deposits	\$ 46,865,487	\$ 45,242,260	\$ (1,623,227)
Interest-bearing deposits	<u>460,250,901</u>	<u>480,799,055</u>	<u>20,548,154</u>
Total deposits	507,116,388	526,041,315	18,924,927
Short-term borrowings	768,311	279,521	(488,790)
Long-term debt	104,967,000	99,959,845	(5,007,155)
Guaranteed preferred beneficial interest in junior subordinated debentures	12,000,000	12,000,000	-
Accrued expenses and other liabilities	<u>7,536,318</u>	<u>6,921,539</u>	<u>(614,779)</u>
Total liabilities	<u>632,388,017</u>	<u>645,202,220</u>	<u>12,814,203</u>
STOCKHOLDERS' EQUITY:			
Preferred A Shares	-	15,540,000	15,540,000
Preferred B Shares	-	777,000	777,000
Common stock - par value	29,420	29,478	58
Additional paid in capital	17,256,603	16,517,649	(738,954)
Retained earnings	34,252,072	34,624,977	372,905
Accumulated other comprehensive income	(32,802)	265,170	297,972
Unearned ESOP shares	<u>(260,275)</u>	<u>(263,394)</u>	<u>(3,119)</u>
Total stockholders' equity	<u>51,245,018</u>	<u>67,490,880</u>	<u>16,245,862</u>
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	<u>\$ 683,633,035</u>	<u>\$ 712,693,100</u>	<u>\$ 29,060,065</u>

FORM OF LETTER AGREEMENT WITH SENIOR EXECUTIVE OFFICERS

TRI-COUNTY FINANCIAL CORP.

[REDACTED]
Tri-County Financial Corporation
3035 Leonardtown Road
Waldorf, Maryland 20601

Dear [REDACTED],

Tri-County Financial Corp. (the "*Company*") anticipates entering into a letter agreement ("*Agreement*") with the United States Department of the Treasury ("*Treasury*") that provides for the Company's participation in the Treasury's Capital Purchase Program (the "*CPP*"). If the Company does not participate in the CPP, this letter shall be of no further force and effect.

For the Company to participate in the CPP and as a condition to the closing of the investment contemplated by the Agreement, the Company is required to meet specified standards for incentive compensation to its senior executive officers and to make changes to its compensation arrangements. To comply with these requirements, and in consideration of the benefits that you will receive as a result of the Company's participation in the CPP, you agree as follows:

(1) *No Golden Parachute Payments.* The Company shall not make any golden parachute payment to you during any period during which (A) you are a senior executive officer and (B) Treasury holds an equity or debt position acquired from the Company in the CPP (a "*CPP Covered Period*").

(2) *Recovery of Bonus and Incentive Compensation.* Any bonus and incentive compensation paid to you during a CPP Covered Period is subject to recovery or "clawback" by the Company if the payments were based on materially inaccurate financial statements or any other materially inaccurate performance metric criteria.

(3) *Compensation Program Amendments.* Each of the Company's compensation, bonus, incentive and other benefit plans, arrangements and agreements (including golden parachute, severance and employment agreements) (collectively, "*Benefit Plans*") with respect to you is hereby amended to the extent necessary to give effect to provisions (1) and (2). For reference, certain affected Benefit Plans are set forth in Appendix A to this letter. If the payments and benefits provided under the Benefit Plans would exceed the golden parachute limitations of the CPP, the payments and benefits shall be reduced or revised, in the manner determined by you (subject to the next sentence), by the amount, if any, which is the minimum necessary to result in no portion of the payments and benefits exceeding the limitations. The Company, at its expense, will determine the extent of any reduction in the payments and benefits to be made pursuant to this letter. In addition, the Company is required to review its Benefit Plans to ensure that they do not encourage senior executive officers to take unnecessary and excessive risks that threaten the

value of the Company. To the extent any such review requires revisions to any Benefit Plan with respect to you, you and the Company agree to negotiate such changes promptly and in good faith.

(4) *Definitions and Interpretation.* This letter shall be interpreted as follows:

(i) "Senior executive officer" means the Company's "senior executive officers" as defined in subsection 111(b)(3) of EESA and 31 C.F.R. § 30.2.

(ii) "Golden parachute payment" has the meaning given to such term in Section 111(b)(2)(C) of EESA and 31 C.F.R. § 30.9.

(iii) "EESA" means the Emergency Economic Stabilization Act of 2008.

(iv) The term "Company" includes any entities treated as a single employer with the Company under 31 C.F.R. § 30.1(b). You are also delivering a waiver pursuant to the Agreement, and, as between the Company and you, the term "employer" in that waiver will be deemed to mean the Company as used in this letter.

(v) The term "CPP Covered Period" shall be limited by, and interpreted in a manner consistent with, 31 C.F.R. § 30.11.

(vi) Provisions (1) and (2) of this letter are intended to, and will be interpreted, administered and construed to, comply with Section 111 of EESA (and, to the maximum extent consistent with the preceding, to permit operation of the Benefit Plans in accordance with their terms before giving effect to this letter).

(5) *Miscellaneous.* To the extent not subject to federal law, this letter will be governed by and construed in accordance with the laws of Maryland. This letter may be executed in two or more counterparts, each of which will be deemed to be an original. A signature transmitted by facsimile will be deemed an original signature.

Yours sincerely,



Name: 
Title: 

Intending to be legally bound, I agree with and accept the foregoing terms on the date set forth below.


Date: December 19, 2008

APPENDIX A

Employment Agreement by and between [REDACTED]
[REDACTED]

Salary Continuation Agreement by and between [REDACTED]
[REDACTED]

Tri-County Financial Corporation 1995 Stock Option and Incentive Plan, as amended

Tri-County Financial Corporation 2005 Equity Compensation Plan, as amended

Community Bank of Tri-County Executive Deferred Compensation Plan