Washington Banking Company

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

March 4, 2009

Re: Washington Banking Company ("WBCO") response to SIGTARP audit request

The following is WBCO's response to your letter dated February 6, 2009:

Request

(1) 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 have taken that you would not have been able to take absent the infusion of TARP funds.

Response

(a) WBCO anticipated using of TARP funds upon receipt in the short term to invest in high quality investment securities pending anticipated loan demand. In the longer term WBCO will either repay the Treasury (should loan demand not develop), or leverage these funds and increase our lending in the local communities that we serve. We are also concerned about the potential deterioration in our loan portfolio should the current economic downturn persist for a prolonged period; the TARP funds bolster our capital ratios and provide a cushion against possible losses.

(b) Immediately following closing, WBCO used a portion of the funds to repay an overnight borrowing and the remainder of the funds were invested in Fed Funds. TARP funds are not segregated from other funds and are part of the overall funding sources for the Company. Therefore the exact disposition of these funds is impossible to determine. No separate account has been created.

(c) It is difficult to state with absolute certainty where the TARP funds have been deployed since they are only a portion of the total pool of funds available to the Company. Deposits from customers are obviously the largest pool of funds along with customer loan and interest payments.

We can report however, that since the receipt of the TARP funds on January 16, 2009 through February 28, 2009 the Bank has originated over $81.5 million in new and renewed loans. This compares with $68.5 million in new and renewed loans for the same period in 2008. We have also purchased $1.25 million in municipal bonds that directly benefit our communities and a $1.0 million government agency security. While it is impossible to say, in hindsight, whether we would have made these loans and investments without the TARP funds, undoubtedly the TARP funds allowed us to feel more comfortable pursuing these opportunities as we are able to maintain stronger capital ratios than we otherwise would have had. This stronger capital position puts us in a better position to work with borrowers who are experiencing difficulties in the current economic environment.

(d) Again, tracing the exact deployment of the TARP funds is not feasible for the reasons previously stated. Nevertheless the additional capital that these funds provide will allow us to work with our borrowers that are experiencing difficulties, potentially modify loans or partially forgive principal indebtedness. Since these funds strengthened our capital position, they will also allow us to continue to lend within our communities even in the event of a prolonged economic recession. The funds also put us in the position of being considered a healthy bank by our regulators, who often seek out partners to participate in the FDIC's "failed bank" process.

We have also enclosed two articles from our local newspaper discussing the Company's receipt of the TARP funds and our intended use of those funds. We cannot certify the accuracy of statements in the article that are not direct quotations of our officers.

<u>Request</u>

(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 or other longer-term or deferred forms of executive compensation.

<u>Response</u>

(a) Washington Banking Company intends to fully comply with the executive compensation requirements of the TARP program. The most recent statutory modifications to the EESA are still being clarified by the Treasury Department and the SEC, and the Company will modify its executive employment contracts and incentive plans as appropriate to maintain compliance with the TARP requirements for as long as the Company retains the TARP capital. Specifically, the Compensation

Committee of the Board of Directors of the Company will be responsible for completing the required assessments of risks and incentive compensation and then recommending any changes to executive contracts and incentive programs to the full Board of Directors. The Committee is currently working with a compensation consultant and our attorney firm to analyze the existing contracts and incentive programs and determine what amendment(s) may be required, if any. It is important to note that we are undergoing our risk analysis with our outside consultants and the process will be completed within the required 90-day limit. Also, at the time we completed our TARP transaction, we had analyzed the compensation requirements and understood that we were already in compliance with key components in that our compensation levels fall well below the $500,000 (formerly $1,000,000) deductibility limitation and our executive employment contracts already include provisions that reference Internal Revenue Code Section 280G limits on golden parachute payments.

I , Richard Shields, 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 statements were made, not misleading.

Sincerely,

Richard Shields
EVP & CFO
Washington Banking Company

Show me the money: Whidbey Island Bank gets its millions

By **JESSIE STENSLAND**
Whidbey News Times Assistant editor
Jan 16 2009

The U.S. Treasury Department wired $26.38 million to Whidbey Island Bank early Friday morning.

The cash infusion makes Washington Banking Company, the holding company for the Oak Harbor-based bank, the latest in a series of healthy banking companies to participate in the federal government's Capital Purchase Program, which is part of the controversial $700 billion Troubled Asset Relief Program.

"It's an extremely prudent move in these tough economic times," Jack Wagner, company president and CEO, told the Whidbey News-Times. He added that the action will keep the bank well capitalized in case the economy continues to deteriorate for years to come.

"We are one of the best run and most profitable banks in the state. Now we will be one of the safest out there for depositors and investors," he added.

Under the program, the federal government purchased $26.38 million in preferred shares and warrants.

Rick Shields, chief financial officer of the bank, said the preferred share is "sort of a cross between common stock and debt." The bank will pay 5 percent a year in dividends on the preferred shares for five years, after which the rate will increase to 9 percent if the shares aren't redeemed.

The federal government also received 492,000 warrants, which Shields describes as "the right to buy a share of common stock" at the set price of $8.04 a share. The price is an average of the company's stock price over a certain period.

The Treasury Department started the program to encourage financial institutions to build capital to increase the flow of financing to businesses and consumers and to support the U.S. economy.

Whidbey Island Bank officials announced in December that they received preliminary approval of an application for the Treasury Department to invest $26.38 million in Washington Banking's preferred stock and common stock warrants.

Tuesday, Washington Bank Company stockholders cleared the final hurdle for the deal to go through. They approved a measure to amend the company's articles of incorporation to increase the number of preferred stock.

Wagner said it makes sense for stockholders to be in favor of the action.

"With all this extra capital, the safety for their investment should certainly be improved," he said.

But the money won't affect the bank's loan practices. He said the bank has maintained the same practices throughout the economic downturn, despite the stories of credit tightening.

"No good loans that have been submitted to our bank have been turned down," he said.

The money from the federal government will be combined with the bank's assets. Wagner said there's really no way to keep it separate in order to track how the treasury funds were used, as some lawmakers have suggested.

Whidbey Island Bank and the parent company are both "well capitalized" under regulatory guidelines.

The company will report fourth quarter earnings next week. According to the third quarter statement, "total shareholders' equity improved to $79 million at September 30, 2008, compared with $78 million at June 30, 2008, and $72 million in the third quarter of 2007."

In addition, the company reported total assets as of Sept. 30, 2008, at $912 million, which was up 5 percent over the year

Whidbey Island Bank is the only bank that still has a headquarters on the island. A group of Whidbey Island business people started it in Coupeville in the early 1960s.

Today, the bank is one of the largest employers on Whidbey Island. It has 19 branches, with nearly 300 employees, in Island, San Juan, Skagit, Snohomish and Whatcom counties. A new branch was opened in Smokey Point last week.

"We're doing fine in this market compared to our peers," Wagner said.

Whidbey News Times Assistant editor Jessie Stensland can be reached at jstensland@whidbeynewstimes.com or 360.675.6611.

County finds banks wary

By **JESSIE STENSLAND**
Whidbey News Times Assistant editor
Feb 23 2009, 1:05 PM · **UPDATED**

At the heart of Island County's latest $1 million budget hole crisis is Treasurer Linda Riffe's inability to find banks willing to deal with the county, mainly because of a 1969 state law that few people were aware of before the economic crisis.

With no banks bidding on the county's investments, Riffe was forced to put the county's money into the Local Government Investment Pool. She said the interest rate is pretty lousy, currently below 1 percent, so the county's investment income will be $1 million less than anticipated this year.

"I had expected an uptick in the third quarter, but now I don't think that will happen until 2010," she said.

Jack Wagner, president of Whidbey Island Bank, said the bank used to bid on all of the county's certificates of deposits, partly as a way to support the local treasurer. The return was usually more than 2 percent. But Whidbey Island Bank officials recently let Riffe know that they couldn't do that anymore.

"It's not a risk we're willing to take," said Rick Shields, vice president and chief financial officer of Whidbey Island Bank.

A hidden problem came to light when the Bank of Clark County in Vancouver, Wash., was shut down earlier this year. The bank had $15 million in uncollateralized public deposits, which are investments from public entities that weren't backed up with collateral in the form of securities.

It turned out that the other banks with public investments were on the hook for the $15 million, under the state's Public Deposit Protection Act. Wagner said nobody was really aware of the law, which had never been applied before.

Under the law, the other banks had to pay the $15 million. The bill for each bank was based on a percentage of deposits in public investments over a year-long period.

For Whidbey Island Bank, the bill was $138,000.

With the possibility of more bank failures, and more large bills, Whidbey Island Bank and other financial institutions in the state are getting out of the business of taking investments from local governments.

"It's not a good result for anyone," Shields said.

Wagner said state officials are talking about requiring that banks have to collateralize 100 percent of all public funds, instead of the current 10 percent requirement. The majority of the other states require 100 percent collateral.

"We could do that, but other banks around the state are really struggling," Wagner said.

A requirement for 100-percent collateral would discourage most banks from taking on public deposits, Shields said, because they either don't have enough cash for collateral or don't want to tie up their money.

"It's a real crisis," Wagner said. "I'm not really sure what's going to happen. It's a bad situation for banks as well as treasurers."

Nonetheless, Whidbey Island Bank remains one of the most profitable among banks based in the state. Washington Banking Company, the holding company for Whidbey Island Bank, reported a profitable fourth quarter of 2008, while most other banks lost money. Washington Banking earned $1.7 million, or $0.18 per diluted share, in the quarter compared to $1.9 million, or $0.19 per diluted share, in the fourth quarter a year ago. In 2008, net income was $8.3

million compared to $9.4 million in 2007.

In January, the bank received $26.38 million from the federal government Capital Purchase Program, which is part of the controversial $700 billion Troubled Asset Relief Program. Shields said a small amount of the money went into investments that can be used as collateral for public funds, but most of the money will be loaned out, as it was intended.

Shields said the bank is dealing with a lot of borrowers in trouble because of the economy, but bank officials are doing everything they can to work with the clients.

"We don't want to foreclose on a home," Shields said. "That's our last option."

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