

First Business Financial Services, Inc.

Form 10-K

March 13, 2009

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**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549**

**FORM 10-K
ANNUAL REPORT PURSUANT TO
SECTION 13 OR 15(d) OF THE
SECURITIES EXCHANGE ACT OF 1934**

For the fiscal year ended December 31, 2008
Commission file number 0-51028

FIRST BUSINESS FINANCIAL SERVICES, INC.

WISCONSIN (State or jurisdiction of incorporation or organization) 401 Charmany Drive Madison, WI (Address of Principal Executive Offices)	39-1576570 (I.R.S. Employer Identification No.) 53719 (Zip Code)
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(608) 238-8008

Registrant's telephone number, including area code

Securities registered pursuant to Section 12(b) of the Act:

Common Stock, \$0.01 par value	The Nasdaq Global Market
Common Share Purchase Rights	The Nasdaq Global Market

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Act. Yes No

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark if the disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer", "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer Accelerated filer
Non-accelerated filer

(Do not check if a smaller reporting
company)

Smaller Reporting
Company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes No

The aggregate market value of the common equity held by non-affiliates computed by reference to the closing price of such common equity, as of the last business day of the registrant's most recently completed second fiscal quarter was approximately \$40.1 million.

As of March 12, 2009, 2,544,519 shares of common stock were outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Part III Portions of the Proxy Statement for the Annual Meeting of Stockholders to be held on May 4, 2009 are incorporated by reference into Part III hereof.

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PART I.

Item 1. Business

General

First Business Financial Services, Inc. (FBFS or the Corporation) is a registered bank holding company incorporated under the laws of the State of Wisconsin and is engaged in the commercial banking business through its wholly-owned banking subsidiaries First Business Bank and First Business Bank Milwaukee (referred to as the Banks). All of the operations of FBFS are conducted through the Banks and certain subsidiaries of First Business Bank. The Banks operate as business banks focusing on delivering a full line of commercial banking products and services tailored to meet the specific needs of small and medium-sized businesses, business owners, executives, professionals and high net worth individuals. The Banks do not utilize its locations to attract retail customers. The Banks generally target businesses with sales between \$2 million and \$50 million. For a more detailed discussion of loans, leases and the underwriting criteria of the Banks, see **Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations – Loans and Leases**. To supplement its business banking deposit base, the Banks utilize wholesale funding alternatives to fund a portion of their assets.

First Business Bank (FBB) is a state bank that was chartered in 1909 under the name Kingston State Bank. In 1990, FBB relocated its home office to Madison, Wisconsin, opened a banking facility in University Research Park, and began focusing on providing high-quality banking services to small and medium-sized businesses located in Madison and the surrounding area. FBB offers a full line of commercial banking products and services in the greater Madison, Wisconsin area, tailored to meet the specific needs of businesses, business owners, executives, professionals and high net worth individuals. FBB's product lines include commercial and consumer cash management services, commercial lending, commercial real estate lending, equipment leasing and personal loans and personal lines of credits to those business owners, executives and high net worth individuals. FBB also offers trust and investment services through First Business Trust & Investments (FBTI), a division of FBB. FBB has two loan production offices in the Northeast Region of Wisconsin to serve Appleton, Wisconsin and Oshkosh, Wisconsin and their surrounding areas.

FBB has two wholly owned subsidiaries that are complementary to the Corporation's business banking services. First Business Capital Corp. (FBCC) is a wholly-owned subsidiary of FBB operating as an asset-based commercial lending company specializing in providing secured lines of credit as well as term loans on equipment and real estate assets primarily to manufacturers and wholesale distribution companies located throughout the United States. First Business Equipment Finance, LLC (FBEF) is a commercial equipment finance company specializing in financing of general equipment to small and middle market companies throughout the United States.

First Madison Investment Corp. (FMIC) and FMCC Nevada Corp. (FMCCNC), operating subsidiaries of FBB and FBCC, respectively, are located in and formed under the laws of the state of Nevada. FMIC was organized for the purpose of managing a portion of the Bank's investment portfolio. FMIC invests in marketable securities and loans purchased from FBB. FMCCNC, a wholly-owned subsidiary of FBCC, invests in loans purchased from FBCC.

First Business Bank Milwaukee (FBB Milwaukee) is a state bank that was chartered in 2000 in Wisconsin. FBB Milwaukee also offers a wide range of commercial banking products and services tailored to meet the specific needs of businesses, business owners, executives, professionals and high net worth individuals in the greater Milwaukee, Wisconsin area through a single location in Brookfield, Wisconsin. Like FBB, FBB Milwaukee's product lines include commercial and consumer cash management services, commercial lending and commercial real estate lending for similar sized businesses as FBB. FBB Milwaukee also offers trust and investment services through a trust service

office agreement with FBB. FBB Milwaukee also offers business owners, executives, professionals and high net worth individuals, consumer services which include a variety of deposit accounts, and personal loans.

In June 2000, FBFS purchased a 51% interest in The Business Banc Group Ltd. (BBG), a corporation formed to act as a bank holding company owning all the stock of a Wisconsin chartered bank to be newly organized and headquartered in Brookfield, a suburb of Milwaukee, Wisconsin. In June 2004,

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all shares of BBG stock were successfully exchanged for FBFS stock pursuant to a conversion option. Subsequent to this transaction, BBG was dissolved. This transaction resulted in FBB Milwaukee becoming a wholly-owned subsidiary of the Corporation.

In December 2001, FBFS formed FBFS Statutory Trust I (Trust), a statutory trust organized under the laws of the State of Connecticut and a wholly-owned financing subsidiary of FBFS. In December 2001, the Trust issued \$10.0 million in aggregate liquidation amount of floating rate trust preferred securities in a private placement offering. Trust also issued common securities of \$310,000 to the Corporation. These securities were to mature 30 years after issuance and were callable at face value after five years. The Trust used the proceeds from the offering to purchase \$10.3 million of 3 month LIBOR plus 3.60% Junior Subordinated Debentures (the Debentures) of the Corporation. On December 18, 2006 the Corporation exercised its right to redeem the Debentures purchased by the Trust. The Trust subsequently redeemed the preferred securities and the Trust was closed.

In September 2008, FBFS formed FBFS Statutory Trust II, (Trust II), a Delaware business trust wholly owned by the Corporation. Trust II completed the sale of \$10.0 million of 10.5% fixed rate trust preferred securities. Trust II also issued common securities in the amount of \$315,000 to the Corporation. Trust II used the proceeds from the offering to purchase \$10.3 million of 10.5% junior subordinated notes (the Notes) of the Corporation. The Corporation has the right to redeem the Notes at any time on or after September 26, 2013. The preferred securities are mandatorily redeemable upon the maturity of the Notes on September 26, 2038. See Note 10 to the Consolidated Financial Statements for additional information.

Available Information

The Corporation maintains a web site at www.firstbusiness.com. This Form 10-K and all of the Corporation's filings under the Securities Exchange Act of 1934, as amended, are available through that web site, free of charge, including copies of annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and any amendments to those reports, on the date that the Corporation files those materials with, or furnishes them to, the Securities and Exchange Commission.

Employees

At December 31, 2008, FBFS had 152 employees which include 126 full-time equivalent employees. No employee is covered by a collective bargaining agreement, and we believe our relationship with our employees to be excellent.

Supervision and Regulation

Below is a brief description of certain laws and regulations that relate to the Corporation and the Banks. This narrative does not purport to be complete and is qualified in its entirety by reference to applicable laws and regulations.

General.

The Banks are chartered in the State of Wisconsin and are subject to regulation and supervision by the Division of Wisconsin Banking Review Board (the Division), and more specifically the Wisconsin Department of Financial Institutions (WDFI), and are subject to periodic examinations. Review of fiduciary operations is included in the periodic examinations. The Banks' deposits are insured by the Deposit Insurance Fund (DIF). The DIF is administered by the Federal Deposit Insurance Corporation (FDIC), and therefore the Banks are also subject to regulation by the FDIC. Periodic examinations of both Banks are also conducted by the FDIC. The Banks must file periodic reports with the FDIC concerning their activities and financial condition and must obtain regulatory approval prior to entering into certain transactions such as mergers with or acquisitions of other depository institutions and opening or acquiring

branch offices. This regulatory structure gives the regulatory authorities extensive direction in connection with their supervisory and enforcement activities and examination policies, including policies regarding the classification of assets and the establishment of adequate loan and lease loss reserves.

Wisconsin banking laws restrict the payment of cash dividends by state banks by providing that (i) dividends may be paid only out of a bank's undivided profits, and (ii) prior consent of the Division is required for the payment of a dividend which exceeds current year income if dividends declared have

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exceeded net profits in either of the two immediately preceding years. The various bank regulatory agencies have authority to prohibit a bank regulated by them from engaging in an unsafe or unsound practice; the payment of a dividend by a bank could, depending upon the circumstances, be considered as such. In the event that (i) the FDIC or the Division should increase minimum required levels of capital; (ii) the total assets of the Banks increase significantly; (iii) the income of the Banks decrease significantly; or (iv) any combination of the foregoing occurs, then the Boards of Directors of the Banks may decide or be required by the FDIC or the Division to retain a greater portion of the Banks' earnings, thereby reducing dividends.

The Banks are subject to certain restrictions imposed by the Federal Reserve Act on any extensions of credit to their parent holding company, FBFS. Also included in this Act are restrictions on investments in the capital stock or other securities of FBFS and on taking of such stock or securities as collateral for loans to any borrower. Under this Act and regulations of the Federal Reserve Board, FBFS and its Banks are prohibited from engaging in certain tie-in arrangements in connection with any extension of credit or any property or service.

The Corporation

FBFS is a financial holding company registered under the Bank Holding Company Act of 1956, as amended (the BHCA), and is subject to regulation, supervision, and examination by the Board of Governors of the Federal Reserve System (the FRB). The Corporation is required to file an annual report with the FRB and such other reports as the FRB may require. Prior approval must be obtained before the Corporation may merge with or consolidate into another bank holding company, acquire substantially all the assets of any bank or bank holding company, or acquire ownership or control of any voting shares of any bank or bank holding company if after such acquisition it would own or control, directly or indirectly, more than 5% of the voting shares of such bank or bank holding company.

In reviewing applications for such transactions, the FRB considers managerial, financial, capital and other factors, including financial performance of the bank or banks to be acquired under the Community Reinvestment Act of 1977, as amended (the CRA). Also, under the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, as amended, state laws governing interstate banking acquisitions subject bank holding companies to some limitations in acquiring banks outside of their home state without regard to local law.

The Gramm-Leach Bliley Act of 1999 (the GLB) eliminates many of the restrictions placed on the activities of bank holding companies. Bank holding companies such as FBFS can expand into a wide variety of financial services, including securities activities, insurance, and merchant banking without the prior approval of the FRB.

Sarbanes-Oxley Act of 2002. The Sarbanes-Oxley Act (SOX) was enacted by the United States Congress to improve the accuracy and reliability of corporate disclosures made pursuant to securities laws, and for other purposes. A primary focus of SOX is to improve the quality and transparency in financial reporting and independent auditor services for public companies. As directed by SOX, the Securities and Exchange Commission (the SEC) adopted rules that require conformance with specific sections of SOX. Section 302 of SOX and related SEC rules require the Corporation's CEO and CFO to certify that they (i) are responsible for establishing, maintaining, and regularly evaluating the effectiveness of the Corporation's internal controls; (ii) have made certain disclosures to the Corporation's auditors and the audit committee of the Corporation's board of directors about the Corporation's internal controls; and (iii) have included information in the Corporation's quarterly and annual reports about their evaluation and whether there have been significant changes in the Corporation's internal controls over financial reporting that have materially affected, or are reasonably likely to materially affect the Corporation.

Section 404 of SOX requires public companies' annual reports to (i) include the company's own assessment of internal control over financial reporting, and (ii) include an auditor's attestation regarding the company's internal control over financial reporting. The primary purpose of internal control over financial reporting is to foster the preparation of

reliable and accurate financial statements. Since SOX was enacted, however, both requirements of SOX 404 have been postponed for smaller public companies such as the Corporation. The Corporation is subject to the first part of Section 404 of SOX. Refer to **Item 9A(T) Controls and Procedures** for the Corporation's assessment. The requirement of an auditor's attestation per the second part of Section 404 of SOX continues to be postponed per temporary Item 308T

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of SEC Regulation S-K. Consequently, no auditor attestation accompanies Management's Annual Report on Internal Control Over Financial Reporting in this annual report.

Emergency Economic Stabilization Act of 2008. On October 3, 2008, President Bush signed into law the Emergency Economic Stabilization Act of 2008 (EESA), giving the U.S. Department of Treasury (UST) authority to take certain actions to restore liquidity and stability to the U.S. Banking markets. Based upon its authority in the EESA, a number of programs to implement EESA have been announced. Those programs include the following:

Capital Purchase Program (CPP). Pursuant to this program, the UST, on behalf of the U.S. government, will purchase preferred stock, along with warrants to purchase common stock, from certain financial institutions, including bank holding companies, savings and loan holding companies and banks or savings associations not controlled by a holding company. The investment will have a dividend rate of 5% per year, until the fifth anniversary of the UST's investment and a dividend rate of 9% thereafter.

During the time the UST holds securities issued pursuant to this program, participating financial institutions will be required to comply with certain provisions regarding executive compensation and corporate governance. Participation in this program also imposes certain restrictions upon an institution's dividends to common shareholders and stock repurchase activities. We have received preliminary approval from the UST to participate in this program and we are in the process of determining whether we will participate in the program. Refer to **Item 7 Management's Discussion and Analysis of Financial Condition and Results of Operations - Liquidity and Capital Resources** for further discussion.

Temporary Liquidity Guarantee Program. This program contained both (i) a debt guarantee component, whereby FDIC will guarantee until June 30, 2012, the senior unsecured debt issued by eligible financial institutions between October 14, 2008 and June 30, 2009; and (ii) an account transaction guarantee component, whereby the FDIC will insure 100% of non-interest bearing deposit transaction accounts held at eligible financial institutions through December 31, 2009. We elected to participate in this program.

Temporary increase in deposit insurance coverage. Pursuant to EESA, the FDIC temporarily raised the basic limit on federal deposit insurance coverage from \$100,000 to \$250,000 per depositor. The EESA provides that the basic deposit insurance limit will return to \$100,000 after December 31, 2009.

The Banks

As state-chartered DIF-insured banks, the Banks are subject to extensive regulation by the WDFI and the FDIC. Lending activities and other investments must comply with federal statutory and regulatory requirements. This federal regulation establishes a comprehensive framework of activities in which an institution can engage and is intended primarily for the protection of the DIF, the FDIC, and depositors.

Insurance of Deposits. The Banks' deposits are insured under the DIF of the FDIC. On December 3, 2008, the Banks elected to participate in the Transaction Account Guarantee (TAG) which is a component of the FDIC Temporary Liquidity Guarantee Program (TLGP) and therefore the basic insurance coverage is temporarily increased to \$250,000 for interest bearing accounts. There is an unlimited guaranty on non-interest bearing transaction accounts and NOW accounts that have an interest rate of less than 0.50%. The increased FDIC insurance limits will be in place until December 31, 2009. The cost for participating in this plan is a 0.10% annualized fee assessed quarterly on balances of noninterest-bearing transaction accounts that exceed the existing deposit insurance limit of \$250,000. Depositors may qualify for additional coverage if the deposit accounts are in different ownership categories. In addition, federal law

provides up to \$250,000 in coverage for self-directed retirement accounts.

The Banks also elected to participate in the Debt Guarantee Program that temporarily guarantees all newly-issued senior unsecured debt, up to 2% of the Corporation's liabilities, issued by the participating entities on or after October 14, 2008 through and including June 30, 2009. The guarantee expires on June 30, 2012. At December 31, 2008, the Banks did not have any debt guaranteed under this program. The cost for this program upon participation is based on an annualized basis points weighted by

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the maturity of the debt multiplied by the amount of debt issued, and calculated for the maturity period of that debt or June 30, 2012, whichever is earlier.

The FDIC assigns each institution it regulates to a particular capital group based on the levels of the institution's capital—well-capitalized, adequately capitalized, or undercapitalized. These three groups are then divided into three subgroups reflecting varying levels of supervisory concern, ranging from those institutions considered to be healthy to those that represent substantial supervisory concern. The result is nine assessment risk classifications, with well-capitalized, financially sound institutions paying lower rates than those paid by undercapitalized institutions that pose a risk to the insurance fund. The Banks' assessment rate depends on the capital category to which they are assigned. Assessment rates for deposit insurance currently range from 5 to 43 basis points. The Banks are well capitalized. The supervisory subgroup to which the Banks are assigned by the FDIC is confidential and may not be disclosed. The Banks' rate of deposit insurance assessments will depend upon the category or subcategory to which the Banks are assigned. We expect the FDIC insurance premium rates to increase in 2009 based upon the proposed regulations. On March 2, 2009, the FDIC announced a proposal to issue a special assessment of 0.20% of deposits that will be assessed on June 30, 2009 and collected by September 30, 2009. While we are still assessing the impact of this special assessment, we expect this charge to have a material impact on our 2009 consolidated financial results if we are unable to pass the expense through to our clients. In general, any increase in insurance assessment, including special assessments, could have an adverse affect on the earnings of the Banks.

Regulatory Capital Requirements. The FRB monitors the capital adequacy of the Banks because on a consolidated basis they have assets in excess of \$500.0 million. A combination of risk-based and leverage ratios are determined by the FRB. Failure to meet these capital guidelines could result in supervisory or enforcement actions by the FRB. Under the risk-based capital guidelines, different categories of assets, including certain off-balance sheet items, such as loan commitments in excess of one year and letters of credit, are assigned different risk weights, based on the perceived credit risk of the asset. These risk-weighted assets are calculated by assigning risk weights to corresponding asset balances to determine the risk weight of the entire asset base. Total capital, under this definition, is defined as the sum of Tier 1 and Tier 2 capital elements, with Tier 2 capital being limited to 100% of Tier 1 capital. Tier 1 capital, with some restrictions, includes common stockholders' equity, any perpetual preferred stock, qualifying trust preferred securities, and minority interests in any unconsolidated subsidiaries. Tier 2 capital, with certain restrictions, includes any perpetual preferred stock not included in Tier 1 capital, subordinated debt, any trust preferred securities not qualifying as Tier 1 capital, specific maturing capital instruments and the allowance for loan and lease losses (limited to 1.25% of risk-weighted assets). The regulatory guidelines require a minimum total capital to risk-weighted assets of 8%, of which at least 4% must be in the form of Tier 1 capital. The FRB also has a leverage ratio requirement which is defined as Tier 1 capital divided by average total consolidated assets. The minimum leverage ratio required is 3%.

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The Corporation and the Banks' actual capital amounts and ratios are presented in the table below and reflect the Banks' well-capitalized positions.

	Actual		Minimum Required for Capital Adequacy Purposes		Minimum Required to be Well Capitalized Under Prompt Corrective Action Requirements	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
As of December 31, 2008						
Total capital (to risk-weighted assets)						
Consolidated	\$ 109,603	12.00%	\$ 73,088	8.00%	N/A	N/A
First Business Bank	91,062	11.13	65,448	8.00	\$ 81,810	10.00%
First Business Bank Milwaukee	14,590	15.13	7,714	8.00	9,642	10.00
Tier 1 capital (to risk-weighted assets)						
Consolidated	\$ 59,178	6.48%	\$ 36,544	4.00%	N/A	N/A
First Business Bank	80,880	9.89	32,724	4.00	\$ 49,086	6.00%
First Business Bank Milwaukee	13,375	13.87	3,857	4.00	5,785	6.00
Tier 1 capital (to average assets)						
Consolidated	\$ 59,178	5.94%	\$ 39,819	4.00%	N/A	N/A
First Business Bank	80,880	9.23	35,064	4.00	\$ 43,830	5.00%
First Business Bank Milwaukee	13,375	10.61	5,042	4.00	6,302	5.00
As of December 31, 2007						
Total capital (to risk-weighted assets)						
Consolidated	\$ 87,018	10.22%	\$ 68,119	8.00%	N/A	N/A

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First Business Bank		79,072	10.45	60,528	8.00	\$ 75,660	10.00%
First Business Bank	Milwaukee	9,847	10.26	7,679	8.00	9,599	10.00
Tier 1 capital (to risk-weighted assets)							
Consolidated		\$ 46,164	5.42%	\$ 34,060	4.00%	N/A	N/A
First Business Bank		71,097	9.40	30,264	4.00	\$ 45,396	6.00%
First Business Bank	Milwaukee	8,639	9.00	3,840	4.00	5,759	6.00
Tier 1 capital (to average assets)							
Consolidated		\$ 46,164	5.12%	\$ 36,065	4.00%	N/A	N/A
First Business Bank		71,097	9.04	31,459	4.00	\$ 39,324	5.00%
First Business Bank	Milwaukee	8,639	7.39	4,678	4.00	5,848	5.00

Prompt Corrective Action. The Banks are also subject to capital adequacy requirements under the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), whereby either Bank could be required to guarantee a capital restoration plan, should it become undercapitalized as defined by FDICIA. The maximum liability under such a guarantee would be the lesser of 5% of the Bank's total assets at the time it became undercapitalized or the amount necessary to bring the Bank into compliance with the capital restoration plan. The Corporation is also subject to the source of strength doctrine per the FRB, which requires that holding companies serve as a source of financial and managerial strength to their subsidiary banks.

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If a bank fails to submit an acceptable restoration plan, it is then considered significantly undercapitalized, and would thus be subject to a wider range of regulatory requirements and restrictions. Such restrictions would include activities involving asset growth, acquisitions, branch establishment, establishment of new lines of business and also prohibitions on capital distributions, dividends and payment of management fees to control persons, if such payments and distributions would cause undercapitalization.

The following table sets forth the FDIC's definition of the five capital categories, in the absence of a specific capital directive.

Category	Total Capital to Risk		Tier 1	Tier 1
	Weighted Assets	Weighted Assets	Capital to Risk Weighted Assets	Leverage Ratio
Well capitalized		³ 10%	³ 6%	³ 5%
Adequately capitalized		³ 8%	³ 4%	³ 4%*
Undercapitalized		< 8%	< 4%	< 4%*
Significantly undercapitalized		< 6%	< 3%	< 3%
Critically undercapitalized	Ratio of tangible equity to total assets	£ 2%		

* 3% if the Banks receive the highest rating under the uniform system.

Limitations on Dividends and Other Capital Distributions. Federal and state regulations impose various restrictions or requirements on state-chartered banks with respect to their ability to pay dividends or make various other distributions of capital. Generally, such laws restrict dividends to undivided profits or profits earned during preceding periods. Also, FDIC insured institutions may not pay dividends while undercapitalized or if such a payment would cause undercapitalization. The FDIC also has authority to prohibit the payment of dividends if such a payment constitutes an unsafe or unsound practice in light of the financial condition of a particular bank. At December 31, 2008, subsidiary unencumbered retained earnings of approximately \$42.7 million could be transferred to the Corporation in the form of cash dividends without prior regulatory approval, subject to the capital needs of each subsidiary.

Liquidity. The Banks are required by federal regulation to maintain sufficient liquidity to ensure safe and sound operations. We believe that the Banks have an acceptable liquidity percentage to match the balance of net withdrawable deposits and short-term borrowings in light of present economic conditions and deposit flows. Refer to **Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations - Liquidity and Capital Resources** for additional information.

Federal Reserve System. The Banks are required to maintain reserves at specified levels against their transaction accounts and non-personal time deposits. As of December 31, 2008, the Banks were in compliance with these requirements. Beginning in October 2008, the FRB began paying a low interest rate on the cash reserves held at the Federal Reserve.

Federal Home Loan Bank System. The Banks are members of the FHLB of Chicago (FHLB). The FHLB serves as a central credit facility for its members. The FHLB is funded primarily from proceeds from the sale of obligations of the FHLB system. It makes loans to member banks in the form of FHLB advances. All advances from the FHLB are

required to be fully collateralized as determined by the FHLB.

As a member, each Bank is required to own shares of capital stock in the FHLB in an amount equal to the greatest of \$500, 1% of its aggregate unpaid residential mortgage loans, home purchase contracts or similar obligations at the beginning of each year or 20% of its outstanding advances. The FHLB also imposes various limitations on advances relating to the amount and type of collateral, the amount of advances and other items. At December 31, 2008, the Banks owned a total of \$2.4 million in FHLB stock and both were in compliance with FHLB requirements. The Banks received no dividends from the FHLB for the year ended December 31, 2008, compared to \$46,000 in cash dividends for the year ended December 31, 2007.

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Since October 2007, the FHLB has been under a consensual cease and desist order with its regulator, the Federal Housing Finance Board. Under the terms of the order, capital stock repurchases and redemptions, including redemptions upon membership withdrawal or other termination, are prohibited unless FHLB has received approval of the Director of the Office of Supervision of the Finance Board. FHLB has not declared or paid a dividend since the third quarter of 2007. As a result of this consensual cease and desist order, the Banks do not expect dividend income from its holdings of FHLB stock to be a significant source of income for the foreseeable future. The Banks currently hold \$2.4 million, at cost, of FHLB stock, of which \$692,000 is deemed voluntary stock. At this time, we believe we will ult