



BANCSHARES™

March 3, 2009

Sent Electronically To: SIGTARP.response@do.treas.gov

Office of the Special Inspector General
Troubled Asset Relief Program
1500 Pennsylvania Ave., N.W., Suite 1064
Washington, D.C. 20220

Dear Ladies and Gentlemen:

On February 9, 2009, we received your request for information, dated February 6, 2009, regarding (1) our use of the funds received pursuant to the Troubled Asset Relief Program ("TARP") Capital Purchase Program ("CPP") and (2) our compliance with the executive compensation restrictions established by the Emergency Economic Stabilization Act of 2008 ("EESA"). This letter responds to your request by reciting the question and then providing a response.

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

- (a) *Hawthorn Bancshares, Inc. is a bank holding company in control of its subsidiary bank, Hawthorn Bank. On December 19, 2008, we received \$30,255,000 in CPP proceeds. Our participation in TARP was based on our management's strategic plan to use the CPP proceeds (i) to allow our subsidiary bank to respond to continued loan demand in our local markets through the extension of credit to small- and medium-sized businesses, home purchasers and consumers; (ii) to make quality, strategic acquisitions if the opportunities for such acquisitions arise in any of our markets; and (iii) faced with the uncertainties as to the depth and duration of the current economic recession, to fortify our capital base, maintain our strong capital ratios and provide additional liquidity. Consistent with the foregoing, in our press release dated December 19, 2008 (which was filed with the SEC as Exhibit 99.1 to our report on Form 8-K dated December 23, 2008) we said, in pertinent part, that:*

Hawthorn decided to accept the Treasury Department's capital offering, ... because we believe that it is in the best interests of our customers, shareholders, and the communities that we serve to keep the supply of funds available for lending and other corporate uses in this economic downturn.

* * *

We plan to use this money to continue to provide loans to our customers and to look for ways that we can deploy additional funds to benefit the communities in our market area.

- (b) *The \$30,255,000 of CPP funds received from the U.S. Treasury was initially placed in Hawthorn Bancshares' non-interest bearing deposit account on our subsidiary bank's balance sheet. While CPP funds have not been segregated from other institutional funds, \$10,000,000 of the initial \$30,255,000 was invested in a newly formed real estate*



company established to hold workout assets purchased from our subsidiary bank. The newly formed real estate company purchased workout loans and other real estate owned properties from Hawthorn Bank to maintain Hawthorn Bank's strong financial position. The balance of the CPP funds (\$20,255,000) continues to be held un-segregated in Hawthorn Bancshares' non-interest bearing account at Hawthorn Bank. [See Attachment A – Unaudited Financials for Hawthorn Bancshares, Inc. and Hawthorn Real Estate LLC.]

- (c) *We received the CPP proceeds a little over two months ago. Since then, as stated under item (b) above, \$10,000,000 of the CPP funds was used to fund a newly formed real estate company. The remaining \$20,255,000 is on deposit at Hawthorn Bank. Hawthorn Bank has not established any new or unique lending programs that will be specifically funded from CPP proceeds; however, Hawthorn Bank does invest in its communities in the aggregate, and as such, gross loans outstanding from December 19, 2008 (receipt date of the CPP funds) through February 27, 2009 grew \$9,200,000 or 5.5% annually. Our loan-to deposit ratio fluctuates at or above 100%, which exemplifies that we have more than exhausted our primary loan funding source and are utilizing "borrowings" to continue supporting loan demand in our market areas. Our commitment to serving our loan communities is further exemplified by the volume of residential real estate loans which have originated since December 19, 2008. Through February 27, 2009, residential real estate loans which we service for the secondary market increased net \$5,000,000. [See Attachment B – Balance Fluctuation Report.]*
 - (d) *With reference to Hawthorn Bancshares' "unspent" CPP funds, we have not currently established any new or unique lending programs, but we continue to closely monitor congressional oversight to align any programs with the various regulatory bodies' expectations.*
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.

In connection with our participation in the CPP program, all of our senior executive officers or CEOs agreed not to accept prohibited golden parachute payments and subjected certain compensation paid to them during the "CPP Period" to review and possible "clawback". The form of our agreement with our CEOs was filed with the SEC as Exhibit 10.3 to our report on Form 8-K dated December 23, 2008. Our Compensation Committee is scheduled to meet March 19, 2009. Agenda items for that meeting include reviewing our executive compensation structure to ensure there are no incentives for unnecessary and excessive risks that may threaten the value of our Company during the CPP Period, as well as considering the effect of the changes to EESA Section 111(b), as amended by the American Recovery and Reinvestment Act of 2009 (ARRA). Our board of directors will continue to confer with and receive guidance from the appropriate company personnel in this regard. We will continue to work to satisfy all certification and other compensation review requirements set forth in EESA, as amended by ARRA, and all regulations that have been or will be promulgated under either statute. Lastly, we are reviewing with our legal counsel our current executive compensation structure to identify any potential conflicts associated with CPP funding requirements and to ensure compliance with Treasury regulations being promulgated to implement ARRA's amendments to EESA Section 111(b). We will make any needed adjustments to comply with those regulations.

As the duly authorized senior executive officer of Hawthorn Bancshares, Inc., I hereby certify the accuracy of all statements, representations and supporting information contained herein, subject to the requirements and penalties set forth in Title 18 of the United States Code, Section 1001. If you should have any questions, I may be reached at (660) 885-2241.

Regards,

James E. Smith
James E. Smith ^{KL3}
Chairman and CEO

Copy:

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Hawthorn Bancshares, Inc.
Unaudited Financials of Hawthorn Bancshares, Inc. & Hawthorn Real Estate LLC
February 27, 2009

Attachment A

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Hawthorn Real Estate, LLC

Financials - unaudited.

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HAWTHORN Bancshares

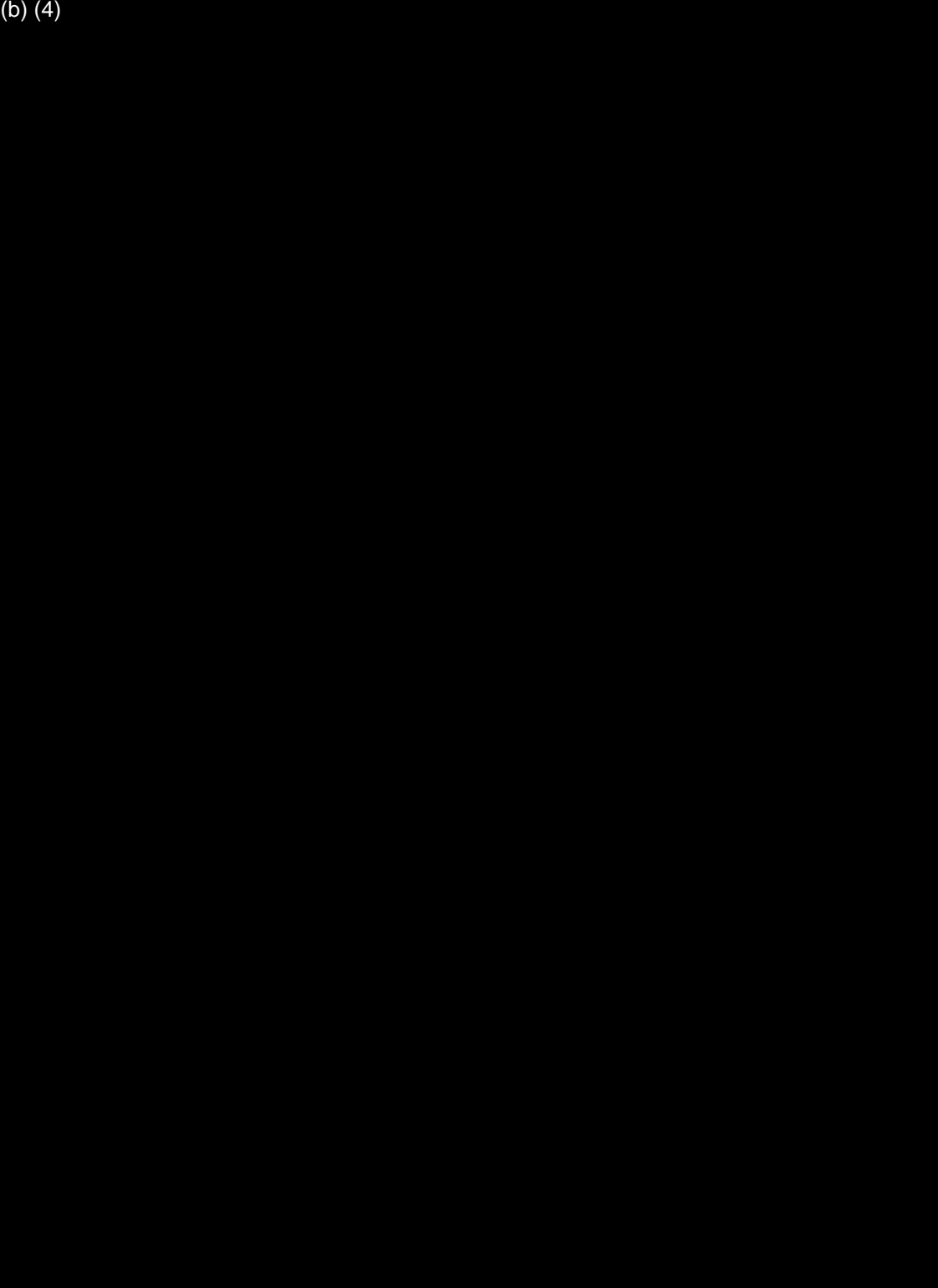
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Hawthorn Bancshares
Financials - unaudited

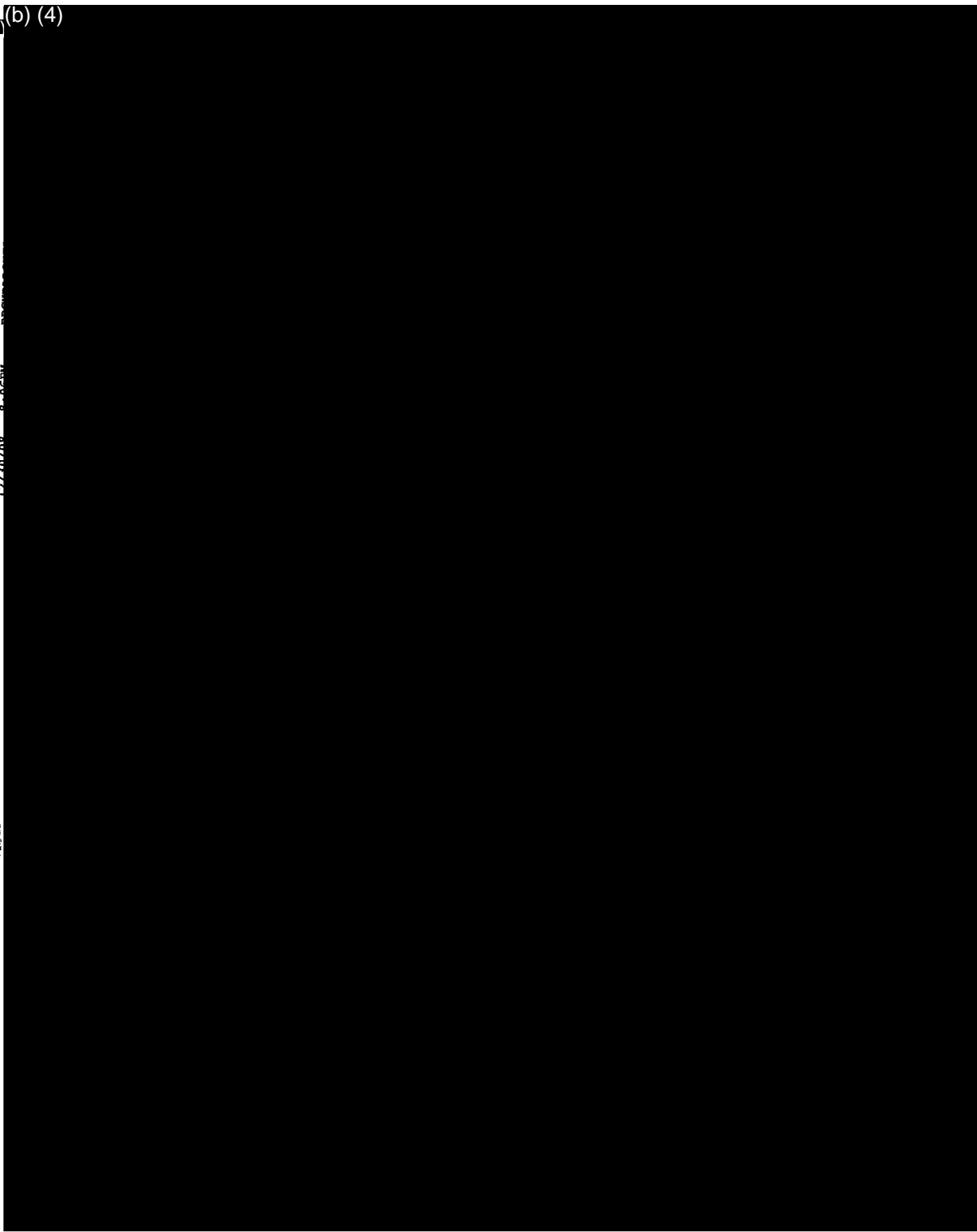
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Hawthorn Bancshares, Inc.
Balance Fluctuation Report
February 27, 2009

Attachment B

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