

# Peoples Bancorp

OF NORTH CAROLINA, INC.

# 194

March 5, 2009

Mr. Neil M. Barofsky  
Office of the Special Inspector General  
Troubled Asset Relief Program  
1500 Pennsylvania Ave. NW, Suite 1064  
Washington, DC 20220

Dear Mr. Barofsky:

In response to your request on February 6, 2009, we are writing to provide you with information on the use by Peoples Bancorp of North Carolina, Inc. (the Company) and its one bank Subsidiary, Peoples Bank (the Bank) of the funds received under the Troubled Asset Relief Program (TARP). The Company received \$25,054,000 (the funds) on December 23, 2008 from the U.S. Treasury and issued 25,054 shares of 5% Preferred Stock in exchange for the Treasury's investment and a warrant to purchase 357,234 shares of the Company's stock. The Company's intent for the use of the Funds was announced in a press release on December 23, 2008 which is attached hereto as Exhibit 1.

The funds were deposited upon receipt into the checking account maintained by the Company at the Bank. The funds were then available at the Bank to lend or invest as part of the Bank's on-going daily operations. It is the intent of the Bank to utilize these funds to make loans to qualified borrowers in our market area. We will also use these funds to absorb losses that we incur when modifying loans or making concessions to borrowers in order to keep borrowers out of foreclosure. The Bank is also working with its current builders and contractors to provide financing for potential buyers who may not be able to qualify for financing in the current mortgage market. The Bank will consider lower interest rates or higher loan-to-value limits in order to help our residential builders sell existing single family homes. The Bank will also use this capital infusion as additional Tier I capital to protect the Bank from potential losses that may be incurred during this current recessionary period.

You ask whether the TARP funds received were segregated from other funds. As mentioned above, the funds were deposited into the Company's checking account held at the Bank, and so the funds were "commingled" with all funds invested or deposited with the Bank. That being said, the Company, in the discussions between Management and the Board of Directors (the Board) when considering whether to apply for and then accept the TARP funds, has identified investment transactions that will invest funds received by the Bank from a variety of sources at a level sufficient to generate earnings for the Company that will offset the cost of the 5% after-tax dividend to be paid on the preferred shares issued to the Treasury. This leveraging process is the normal activity for a financial institution, i.e., lending or investing capital and "borrowed" funds, (deposits, FHLB borrowing, etc.) in order to provide a return on capital.

Peoples Bank

Real Estate Advisory Services, Inc.

Peoples Investment Services, Inc.

P.O. Box 467

Newton, NC 28658-0467

Telephone: 828-464-5620

Fax: 828-465-6780

As is shown on Exhibit 2 in the original presentation to the Board, the Bank would need to add loans and investments of nearly eight times the amount of TARP received to offset the cost to equity of the preferred shares issued to The Treasury.

In response to Item (1) (c) in your letter, we have disbursed \$14.1 million in new loans covering the period from December 23, 2008 to February 11, 2009. This includes commercial, consumer, and mortgage loans granted to individual consumers and commercial customers. This also includes \$2,066,000 in "non-conforming" loans where the borrower or the property owner would not conform to secondary market requirements or for "work out" situations for existing customers. We also have six loans where payments have been modified or interest forgiven in order to keep borrowers from foreclosure.

(b) (8)

(b) (8) we expect to lend the \$25.1 million received to the extent that qualified borrowers present lending requests to the Bank. As shown in the paragraph above, the Bank is making loans to qualified borrowers and intends to continue doing so for the foreseeable future. This includes making loans to qualified borrowers who have been turned down from other financial institutions who may not have adequate capital to support their loans or may have just curtailed their lending activities. We have seen this numerous times so far in 2009 and expect this to continue. Without the addition of capital from the Capital Purchase Program, I believe that Peoples Bank would be significantly more restrictive in its lending capabilities and in its ability to assist borrowers to mitigate foreclosures.

Item (2) addresses the Company's plans to meet the compensation requirements of the Capital Purchase Program. Each of the senior executive officers entered into a letter agreement with the Company that provides that each of the officers acknowledges and agrees that he is not entitled to golden parachute payments, that bonus and other incentive compensation must be returned if it is determined that it was based on materially inaccurate financial statements or other materially inaccurate performance metric system and that each of the Company's compensation, bonus and incentive compensation plans are amended to comply with the executive compensation provisions of TARP. We also believe that the letter agreement is comprehensive in scope so as to cover the executive compensation restrictions contained in the American Recovery and Reinvestment Act of 2009. A copy of the letter agreement between Tony W. Wolfe and the Company is attached hereto as Exhibit 4. All of the letter agreements are identical and all were filed with the SEC in a Form 8-K on December 29, 2008. The Company and its officers are in compliance with the requirements as set forth, as no officer has contractual arrangement that would provide for Golden Parachute Payments. There are no benefit plans in place that encourage executive officers to take unnecessary and excessive risks that threaten the value of the Company. Because the Executive Compensation Plan was not affected by the Department of Treasury guidelines, no changes will be made to other longer-term or

deferred forms of executive compensation. A copy of the Executive Officers' objectives for participation in the Management Incentive Plan is attached as Exhibit 5. The

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The use of these objectives would actually incent the officers to take less risk. The Company understands and agrees that no bonuses or incentive compensation have been paid nor will be paid to any senior executive officers so long as such restrictions are in effect and applicable to the Company.

In connection with your request, I have attached copies of presentations made to the Board of Directors specifically related to participation in the Capital Purchase Program. The first presentation, Exhibit 2, done on November 6, 2008, includes a cover memo and four additional pages showing potential changes in capital and potential loan losses that could impact the Company's capital position. The last two pages look at the impact to capital and earnings ratios with and without the TARP financing and display the impact of three separate leverage scenarios on the cost of the TARP funds.

The second presentation, Exhibit 6, was given to the Board on December 18, 2008. It again has a cover memo describing the attached documents and giving Management's recommendation. This presentation again shows the impact to the Company's capital position, and on Page 5 of Exhibit 6, shows the total amount of assets that must be acquired at several potential interest rate spreads to cover the cost of the 5% Preferred Stock. It is stated in Management's recommendation on Page 1 of the Exhibit that funds acquired under the CPP would be invested in loans and investment securities.

We appreciate this opportunity to share with you the manner in which Peoples Bancorp of North Carolina, Inc. and its subsidiary, Peoples Bank, have made use of, and will continue to utilize, the funds received from The Department of the Treasury as part of the Capital Purchase Program under the Temporary Asset Relief Program. We believe that we have complied with all requirements as put forth by the Department of the Treasury at the time of receipt of funds on December 23, 2008 (b) (8)

(b) (8)

If you require any additional information, please contact me at

(b) (6)

Sincerely,

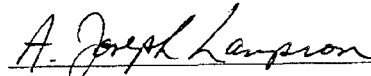


A. Joseph Lampron

Executive Vice President and Chief Financial Officer

Attachments: Exhibits 1,2,3,4,5, and 6

"I, A. Joseph Lampron, Executive Vice President and Chief Financial Officer of Peoples Bancorp of North Carolina, Inc. and Peoples Bank, 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 such statements were made, not misleading.

  
A. Joseph Lampron

## Peoples Bancorp of North Carolina, Inc. Announces It Has Received \$25.1 Million as an Approved Participant in the U.S. Treasury Department TARP Capital Purchase Program

Company Release - 12/23/2008 15:07

NEWTON, N.C., Dec. 23 /PRNewswire-FirstCall/ -- Peoples Bancorp of North Carolina, Inc. (the "Company") (Nasdaq: PEBK), the parent company of Peoples Bank (the "Bank") announced today that it has received \$25.1 million as an approved participant in the U.S. Treasury Department's TARP Capital Purchase Program. The Company issued 25,054 shares of senior preferred stock and a related warrant for 357,234 shares of PEBK common stock, which represents 15% of the senior preferred stock or \$3.8 million to the U.S. Treasury.

The CPP, created by the U.S. Treasury, is a voluntary program in which selected, healthy financial institutions are encouraged to participate. Approved use of the funds includes providing credit to qualified borrowers, either as companies or individuals, among other things. Such participation is intended to support the economic development of the community and thereby restore the health of the local and national economy.

Tony W. Wolfe, President and Chief Executive Officer of Peoples Bancorp, characterized the Company's participation in the program by saying, "We are pleased that our financial strength qualified our Company to participate in the program. We view this as a vote of confidence in our Company, our management and our employees. Peoples Bank has been an active, community-based lender for 96 years. The TARP money will enable us to provide even greater support for the economic development of our communities."

Before receiving the TARP funds, Peoples Bank was well-capitalized as measured by all regulatory guidelines. On September 30, 2008, the Company's Tier 1 Leverage Capital Ratio was 9.92%, and its Total Risk-Based Capital Ratio was 12.10%. Based on the September 30, 2008, financial statements, the addition of new capital through the Treasury's CPP will increase the Company's Tier 1 Leverage Capital Ratio to approximately 12.64% and Total Risk-Based Capital Ratio to approximately 15.10%.

The preferred stock issued by the Company will pay a 5% dividend for the first 5 years, after which the rate will increase to 9% if the Company does not redeem the preferred shares. These preferred shares do not carry voting rights, except in certain limited circumstances. The Company issued the preferred shares and warrants only to the U. S. Treasury, not to any other third parties. Terms and conditions of the transaction and the preferred stock will conform to those provided by the U.S. Treasury. A summary of the Capital Purchase Program can be found at the Treasury's web site: [www.ustreas.gov/initiatives/eesa](http://www.ustreas.gov/initiatives/eesa).

Peoples Bank operates entirely in North Carolina, with 11 offices in Catawba County, one in Alexander County, three in Lincoln County, three in Mecklenburg County, one in Union County, one in Iredell County and one in Wake County. The Company's common stock is publicly traded and is quoted on Nasdaq under the symbol "PEBK."

For further information contact: Tony W. Wolfe, President and Chief Executive Officer, or A. Joseph Lampron, Executive Vice President and Chief Financial Officer of Peoples Bancorp of North Carolina, Inc. Phone: 828-464- 5620. Fax: 828-465-6780.

Statements made in this press release, other than those concerning historical information, should be considered forward-looking statements pursuant to the safe harbor provisions of the Securities Exchange Act of 1934 and the Private Securities Litigation Act of 1995. These forward-looking statements involve risks and uncertainties and are based on the beliefs and assumptions of management and on the information available to management at the time this release was prepared. These statements should be recognized by the use of words like "expect," "anticipate," "estimate," and "believe," or variations of these words and similar expressions. Readers should not place undue reliance on forward-looking statements, as a number of important factors could cause actual results to differ materially from those in the forward-looking statements. Factors that could cause actual results to differ materially include, but are not limited to, (1) competition in the markets served by Peoples Bank; (2) changes in the interest rate environment; (3) general national, regional or local economic conditions being less favorable than expected that may result in, among other things, a deterioration in credit quality and the possible impairment of collectability of loans; (4) legislative or regulatory changes, including changes in accounting standards; (5) significant changes in the federal and state legal and regulatory environment and tax laws; (6) the impact of changes in monetary and fiscal policies, laws, rules and regulations, and (7) other risks and factors identified in the Company's other filings with the Securities and Exchange Commission, including but not limited to, those described in the Peoples Bancorp of North Carolina, Inc. annual report on Form 10-K for the year ended December 31, 2007.

SOURCE Peoples Bancorp of North Carolina, Inc.

Contact: Tony W. Wolfe, President and Chief Executive Officer, or A. Joseph Lampron, Executive Vice President and Chief Financial Officer, both of Peoples Bancorp of North Carolina, Inc., +1-828-464-5620, or Fax: +1-828-465-6780

[Click here for Printer-Friendly Version](#)

**CONFIDENTIAL**

Exhibit 2 (page 1 of 5)

Board Meeting

11/6/08

①

**From:** Joe Lampron

**Sent:** Tuesday, November 04, 2008 02:09 PM

**To:** Directors DL

**Cc:** (b) (6) Bill Cable; Joe Beaman; Lance Sellers; Tony Wolfe

**Subject:** Confidential: Info for Thursday

**Attachments:** Updated FAQ 11-4-08.pdf; Financial Impact 11-4-08.pdf

The meeting this Thursday will be for the purpose of determining whether the Company will participate in the Capital Purchase Program (CPP) being made "available" by the Treasury. (b) (6) from Brooks Pierce will be in attendance to discuss the legal aspects of the program. The attached two documents provide information to assist in deciding whether we want to participate in the program. (b) (4)

(b) (4) While we are currently well-capitalized as defined by the regulators, a worsening of the current economic conditions could significantly reduce the level of excess capital that we have today. It would appear that the investment community now expects healthy banks to take this capital. Banks without significant excess capital (b) (4) that do not take this will be questioned as to why they would not take it. We feel, that when considering all factors, it would be appropriate to participate in the CPP. We will be recommending that we participate at the 3% level or approximately \$25 million.

If you have questions or comments, please contact Tony or me.

Joe

Updated FAQ - updated responses to questions listed on the ABA website.

Financial Impact worksheets:

(b) (4)

Loan Stress Test – this is the updated Stress Test for the Holding Company looking at potential losses within the loan portfolio and determining the amount of additional losses we could absorb and remain Well-Capitalized. (b) (4)

(b) (4)

TARP Capital Analysis – the last two pages look at the impact to our capital ratios and earnings at a 1% and a 3% capital infusion. This is a worksheet provided by one of our investment brokers. The bottom of the first page shows the total projected cost of the capital at each level on an annual basis. The second worksheet looks at various levels of asset growth (purchasing investment securities and borrowing using brokered CD's) to determine the level necessary to offset the total impact of the TARP capital on EPS.

Peoples Bancorp of North Carolina, Inc.  
Capital Ratio Projections  
Assuming no new capital

Projected  
2008 Total

(b) (4)

(b) (4)

Cash dividend/share  
Cash dividends paid  
YTD net income  
Cash dividend payout ratio  
EPS  
P/E ratio

Stock dividend

Stock repurchased (\$)  
# of shares repurchased

Total Risk-Based Capital/Risk-Adjusted Assets  
Tier I Risk-Based Capital/Risk-Adjusted Assets  
Tier I Leverage Capital/Average Total Assets  
Total Capital/Average Total Assets

Excess capital > 10.50% (Total risk-based)

**Assumptions:**

Shares outstanding  
Stock price  
Asset growth rate  
Net income growth rate  
Total loans  
Allowance for loan losses to total loans

**Peoples Bancorp  
Projected Capital Ratios  
Loan Loss Stress Test**

TOTAL TIER I CAPITAL		09/30/2008	91,329
Projected Earnings 2008			(b) (4)
Less: - 9/30/08 YTD earnings			(5,993)
Dividends	# of shs	5,589	
	rate	\$0.12	
	# of qtrs	1	(671)
Year End Capital			(b) (4)
Stress Test Loss on CRE		(8,397)	
Stress Test Loss on W-7 Mortgages		(3,652)	
Add back losses in Current Budget		0	
		(12,049)	
Tax Impact		64.00%	(7,711)
Adjustment to Allowance for Loan Losses			
Projected total loans at 12-31-08		773,104	
Less: CRE Loans charged-off with Stress Test		(35,370)	
Less: W-7 Loans charged-off with Stress Test		(11,722)	
		726,013	
ALLL / Total Loans ratio		1.25%	
		9,075	
Projected ALLL in current budget		9,664	
		589	
Tax Impact		64.00%	377
Ending Capital after Loan Losses	Tier I		(b) (4)
<b>Tier II Capital</b>			
<b>Total Capital</b>			
<b>Capital Ratios using 7/31/08 Projected Average Assets</b>			<b>Actual Capital Ratios</b>
			<b>09/30/2008</b>
<b>Total Risk-Based Capital/Risk-Adjusted Assets</b>		11.17%	12.10%
<b>Tier I Risk-Based Capital/Risk-Adjusted Assets</b>		10.09%	10.94%
<b>Tier I Leverage Capital/Average Total Assets</b>		9.15%	9.92%
<i>Total Capital/Average Total Assets</i>		10.13%	10.98%
Capital in excess of 10% Requirement for "Well-Capitalized"		\$9,824	
Amount of losses before tax to get to 10% Total Capital to Risk-Based Assets		\$15,350	



Peoples Bank  
TARP Capital Analysis

Exhibit 2 (page 4 of 5)

**CAPITAL IMPACT**

	Prior to TARP	After TARP Financing	
		1% Risk-Weighted Assets	3% Risk-Weighted Assets
Total Assets	\$964,022,173	\$972,373,513	\$989,076,193
Total Risk-Weighted Assets	\$835,134,000	\$836,804,268	\$840,144,804
Total Equity Capital	\$73,226,269	\$81,577,609	\$98,280,289
Senior Preferred Stock from TARP		\$8,351,340	\$25,054,020
Increase in Legal Lending Limit (Assumes 10%)		\$835,134	\$2,505,402
Tier 1 Capital	\$91,329,000	\$99,680,340	\$116,383,020
Tier 1 Capital Ratio	9.47%	10.25%	11.77%
Total Risk-Based Capital	\$101,092,000	\$109,443,340	\$126,146,020
Total Risk-Based Capital Ratio	12.10%	13.08%	15.01%

**DILUTIVE EFFECT OF WARRANTS OR PHANTOM STOCK**

	Stand Alone Book Value	Shares Outstanding (Prior to Transaction)	Strike Price of Warrants	After TARP Financing	
				1% Risk-Weighted Assets	3% Risk-Weighted Assets
Senior Preferred Stock from TARP	\$73,226,269.00	5,589,056	\$11.11	\$8,351,340	\$25,054,020
Principal Amount of Warrants				\$1,252,701	\$3,758,103
Additional Shares - Warrants				112,754	338,263
Pro Forma Diluted Shares Outstanding				5,701,810	5,927,319
% of Shares Outstanding Owned by Treasury				1.98%	5.71%
Pro Forma Book Value				\$71,778,206.07	\$69,047,357.70
Change in Book Value due to TARP Warrants				\$(1,448,062.93)	\$(4,178,911.30)
Dilution to Book Value				-1.98%	-5.71%

**PROJECTED COST OF TARP ACQUISITION**

	1% Risk-Weighted Assets	3% Risk-Weighted Assets
TARP Capital Dividend (5.00% Tax-Affected)	\$417,567	\$1,252,701
Implied Warrant Cost (Projected)	\$100,216	\$300,648
<b>Total Projected Cost</b>	<b>\$517,783</b>	<b>\$1,553,349</b>

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**EARNINGS IMPACT**

Assumed Net Income	\$7,500,000	
Current Earnings Per Share	\$1.34	<b>After TARP Financing</b>
		<i>1% Risk-Weighted Assets    3% Risk-Weighted Assets</i>
<b>Assuming No Asset Growth</b>		
Diluted Earnings Per Share		\$(0.018)                      \$(0.051)
<b>Assuming Leveraging TARP Capital 4X</b>		
Total Assets	\$997,427,533	\$1,064,238,253
Diluted Earnings Per Share	\$1.315	\$1.264
Change in Earnings Per Share	\$(0.027)	\$(0.078)
Tier 1 Capital Ratio	9.99%	10.94%
Total Risk-Based Capital Ratio	13.00%	14.75%
<b>Assuming Leveraging TARP Capital 8X</b>		
Total Assets	\$1,030,832,893	\$1,164,454,333
Diluted Earnings Per Share	\$1.372	\$1.429
Change in Earnings Per Share	\$0.030	\$0.087
Tier 1 Capital Ratio	9.67%	9.99%
Total Risk-Based Capital Ratio	12.90%	14.41%
<b>Assuming Leveraging TARP Capital 12X</b>		
Total Assets	\$1,064,238,253	\$1,264,670,413
Diluted Earnings Per Share	\$1.429	\$1.594
Change in Earnings Per Share	\$0.087	\$0.252
Tier 1 Capital Ratio	9.37%	9.20%
Total Risk-Based Capital Ratio	12.80%	14.09%

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# Peoples Bancorp

OF NORTH CAROLINA, INC.

(b) (8)

REGULATORY AGREEMENTS

List any exceptions to the representation and warranty in Section 2.2(s) of the Securities Purchase Agreement – Standard Terms.

If none, please so indicate by checking the box

11

[\(Back To Top\)](#)

**Section 6: EX-10.A.I (EXHIBIT 10(A)(I))**

Exhibit 10(a)(i)

December 23, 2008

Tony W. Wolfe  
518 West C. Street  
Newton, NC 28658

Dear Tony,

Peoples Bancorp of North Carolina, Inc. (the "Company") anticipates entering into a Securities Purchase Agreement (the "Participation Agreement") with the United States Department of Treasury (the "Treasury") that provides, among other things, for the purchase by the Treasury of securities issued by the Company. This purchase is anticipated to occur as part of the Company's participation in the Treasury's Troubled Asset Relief Program - Capital Purchase Program (the "CPP").

As a condition to the closing of the investment contemplated by the Participation Agreement, the Company is required to take certain actions with respect to compensation arrangements of its senior executive officers. The Company has determined that you are or may be a senior executive officer for purposes of the CPP. To comply with the requirements of the CPP, and in consideration of the benefits that you will receive as a result of the Company's participation in the CPP and for other good and valuable consideration, the sufficiency of which you hereby acknowledge, you agree as follows:

- (1) **No Golden Parachute Payments.** You will not be entitled to receive from the Company any golden parachute payment (as defined below) during any period in which the Treasury holds an equity or debt position acquired from the Company in the CPP (the "CPP Covered Period") (or during the year following any acquisition of the Company, to the extent required by the CPP Limitations (as defined below)).
- (2) **Recovery of Bonus and Incentive Compensation.** You will be required to and shall return to the Company any bonus or incentive compensation paid to you by the Company during the CPP Covered Period if such bonus or incentive compensation is paid to you 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 (all such plans, arrangements and agreements, the "Benefit Plans") are hereby amended to the extent necessary to give effect to provisions (1) and (2) of this letter.

The Company is also required as a condition to participation in the CPP to review the Benefit Plans to ensure that the Benefit Plans do not encourage its senior executive officers to take unnecessary and excessive risks that threaten the value of the Company. To the extent that the Company determines that the Benefit Plans must be revised as a result of such review, or determines that the Benefit Plans must otherwise be revised to comply with Section 111(b) of the EESA (as defined below) as implemented by any guidance or regulation thereunder that has been issued and is in effect as of the closing date of the Company's issuance of preferred stock and warrants to acquire common stock to the Treasury pursuant to the CPP (the "CPP Limitations"), you and the Company agree to negotiate and effect such changes promptly and in good faith.

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- (4) Definitions and Interpretation. This letter shall be interpreted as follows:
- “Senior executive officer” means the Company’s “senior executive officers” as defined in Q&A 2 of the Interim Final Rule issued by the Treasury at 31 CFR Part 30, effective on October 20, 2008 (the “Interim Final Rule”).
  - “Golden parachute payment” shall have the meaning set forth in Q&A 9 of the Interim Final Rule.
  - The term “Company” includes any entities treated as a single employer with the Company under Q&A 1 and Q&A 11 of the Interim Final Rule.
  - This letter is intended to, and shall be interpreted, administered and construed to comply with Section 111 of the Emergency Economic Stabilization Act of 2008 (the “EESA”) and the regulations and guidance promulgated thereunder (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 the State of North Carolina. 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.
- (6) If the Treasury does not purchase the securities contemplated by the Participation Agreement, then this letter shall be of no force or effect. In addition, upon such time as the Treasury no longer holds securities or debt of the Company acquired under the CPP, this letter shall be of no further force or effect, except to the extent required by the CPP Limitations. If you cease to be a senior executive officer of the Company for purposes of the CPP, you shall be released from the restrictions and obligations set forth in this letter to the extent permissible under the CPP. If it is determined that you are not a senior executive officer of the Company as of the date hereof, this letter shall be of no force or effect.

The Company appreciates the concessions you are making and looks forward to your continued leadership during these financially turbulent times.

*[Signature page follows]*



Participation in the Capital Purchase Program  
Management Recommendation  
12/18/08

## Capital Purchase Program

- PEBK has received Preliminary Approval to participate in the Capital Purchase Program (CPP) from the US Treasury (UST)
- May issue preferred stock to the US Treasury totaling \$8.3 million to \$25.1 million
- Would also issue Warrants to purchase PEBK common stock totaling 3% of the preferred stock issuance if preferred stock is issued
- Would sign agreement with UST which would included restrictions on:
  - Dividends – may not pay a cash dividend on PEBK common stock greater than the last dividend granted without getting UST approval
  - Executive Compensation – would not be able to make payments under terms of employment contracts that are considered “Golden Parachute” payments. Current employment contracts with PEBK management do not have any provisions that would be considered “Golden Parachute” payments.

## Management Recommendation

Management recommends that preferred stock totaling \$25,054,000 be issued, taking the full 3% of Risk-Weighted assets available. Funds will be invested in either loans or investment securities. Would intend to leverage the borrowings to attempt to offset total cost of capital.

## Justification:

- Defensive measure – Management believes that the additional capital would position the Bank to remain “Well-Capitalized” (as currently defined) even if loan losses exceed the stress test levels (Page 3)
  - Potential for Loan Losses - Maximum CPP as a % of (Page 4):
    - Total Speculative Loans plus Banco 10%
    - Total CRE plus Banco 6%
- Market perception – impact to PEBK stock price – our capital level before CPP, while sufficient to meet regulatory guidelines, would be perceived as inadequate after peers get CPP
- Limited availability of other sources of capital
  - Trust Preferred market currently gone
  - Other sources (preferred stock, sub debt) at much higher rates than CPP (Gateway issued debt at 12%)
- Support future growth – this will provide capital to allow expansion and “filling out” existing markets

## Repayment of Preferred Shares

- (b) (4)



Costs:

Dividends on Preferred Stock:

Years 1-5	5%
Year 6 and beyond	9%
Cost of Warrants -	\$171,500 annually using maximum issuance

All costs are paid from net earnings – no impact to operating earnings. These costs will reduce the amount available to pay to common shareholders

See Page 5 for a calculation of the impact to income available to common Shareholders and the amount of additional earning assets (leverage) we would have to add to generate the necessary earnings at the net interest spread shown (net between yield on assets and cost of liabilities).



**Peoples Bancorp  
Projected Capital Ratios  
Loan Loss Stress Test**

3

TOTAL TIER I CAPITAL	09/30/2008	91,329
Projected Earnings 2008		(b) (4)
Less: - 9/30/08 YTD earnings		(5,993)

Dividends:	# of shs	5,589	
	rate	\$0.12	
	# of qtrs	1	(671)
Year End Capital			(b) (4)

Stress Test Loss on CRE	(8,397)	
Stress Test Loss on W-7 Mortgages	(3,652)	
Add back losses in Current Budget	0	
	(12,049)	
Tax Impact	64.00%	(7,711)

Adjustment to Allowance for Loan Losses	
Projected total loans at 12-31-08	773,104
Less: CRE Loans charged-off with Stress Test	(35,370)
Less: W-7 Loans charged-off with Stress Test	(11,722)
	726,013
ALLL / Total Loans ratio	1.25%
	9,075
Projected ALLL in current budget	9,664
	589
Tax Impact	64.00%

Ending Capital after Loan Losses	Tier I	(b) (4)
<b>Tier II Capital</b>		
<b>Total Capital</b>		

**Actual Capital Ratios**

		<u>09/30/2008</u>
<u>Capital Ratios using 7/31/08 Projected Average Assets</u>		
<b>Total Risk-Based Capital/Risk-Adjusted Assets</b>	11.11%	12.10%
<b>Tier I Risk-Based Capital/Risk-Adjusted Assets</b>	10.03%	10.94%
<b>Tier I Leverage Capital/Average Total Assets</b>	9.10%	9.92%
<i>Total Capital/Average Total Assets</i>	10.08%	10.98%

Capital in excess of 10% Requirement for "Well-Capitalized"	\$9,324
Amount of losses before tax to get to 10% Total Capital to Risk-Based Assets	\$14,569

Loan Segments with Greatest Market Risk

		TARP Injection			
		1%	1.5%	2%	3%
		8,351,000	12,526,500	16,702,000	25,053,000
<b><u>Total Speculative Loans plus Banco Mortgages</u></b>					
Speculative Construction Loans	76,536,142	11%	16%	22%	33%
Speculative A & D Loans	125,614,982	7%	10%	13%	20%
Banco Mortgages	58,436,375	14%	21%	29%	43%
	<u>260,587,500</u>	3%	5%	6%	10%
<b><u>Total CRE Loans plus Banco Mortgages</u></b>					
Total CRE	335,906,193	2%	4%	5%	7%
Banco Mortgages	58,436,375	14%	21%	29%	43%
	<u>394,342,568</u>	2%	3%	4%	6%

**PEOPLES BANCORP CAPITAL RATIOS**

	09/30/2008	% of Bancorp Risk Weighted Assets			
		1%	1.5%	2%	3%
<i>Additional capital</i>		8,351,340	12,527,010	16,702,680	25,054,020
Potential Earnings	4.00%	384,162	576,242	768,323	1,152,485
Estimated Income Taxes	36.00%	(138,298)	(207,447)	(276,596)	(414,895)
Estimated Increase in Net Income		245,863	368,795	491,727	737,590
Dividend on Preferred Stock		(417,567)	(626,351)	(835,134)	(1,252,701)
Amortization of Implied Warrant Costs (after tax)		(46,919)	(70,378)	(93,837)	(140,756)
Dividend on Warrants when converted		(57,174)	(85,761)	(114,348)	(171,521)
Decrease in Income available to Common Shareholders from CPP		(275,796)	(413,694)	(551,592)	(827,388)
Before Tax Earnings Required		430,931	646,397	861,862	1,292,794
	<b>Spread</b>				
Assets required to generate earnings	0.50%	86,186,261	129,279,391	172,372,488	258,558,733
Leverage Rate		10.3 x	10.3 x	10.3 x	10.3 x
Assets required to generate earnings	1.00%	43,093,130	64,639,696	86,186,244	129,279,366
Leverage Rate		5.2 x	5.2 x	5.2 x	5.2 x
Assets required to generate earnings	1.50%	28,728,754	43,093,130	57,457,496	86,186,244
Leverage Rate		3.4 x	3.4 x	3.4 x	3.4 x

6

**PEOPLES BANK CONSOLIDATED CAPITAL RATIOS**

	09/30/2008	% of Bancorp Risk Weighted Assets			
		1%	1.5%	2%	3%
<i>Additional capital</i>		8,351	12,527	16,703	25,054
Adjusted Risk Weighted Assets	832,769	832,769	832,769	832,769	832,769
Average Total Assets (1)	919,132	919,132	919,132	919,132	919,132
Tier I Capital (2)	82,517	90,868	95,044	99,220	107,571
Tier II Capital	9,763	9,763	9,763	9,763	9,763
Total Capital	92,280	100,631	104,807	108,983	117,334
Total Risk-Based Capital/Risk-Adjusted Assets	11.08%	12.08%	12.59%	13.09%	14.09%
Tier I Risk-Based Capital/Risk-Adjusted Assets	9.91%	10.91%	11.41%	11.91%	12.92%
Tier I Leverage Capital/Average Total Assets	8.98%	9.89%	10.34%	10.79%	11.70%
<i>Total Capital/Average Total Assets</i>	<i>10.04%</i>	<i>10.95%</i>	<i>11.40%</i>	<i>11.86%</i>	<i>12.77%</i>

**PEOPLES BANCORP CAPITAL RATIOS**

	09/30/2008	% of Bancorp Risk Weighted Assets			
		1%	1.5%	2%	3%
<i>Additional capital</i>		8,351	12,527	16,703	25,054
Adjusted Risk Weighted Assets	835,134	835,134	835,134	835,134	835,134
Average Total Assets (1)	920,419	920,419	920,419	920,419	920,419
Tier I Capital (2)	91,329	99,680	103,856	108,031	116,383
Tier II Capital	9,763	9,763	9,763	9,763	9,763
Total Capital	101,092	109,443	113,619	117,794	126,146
Total Risk-Based Capital/Risk-Adjusted Assets	12.10%	13.10%	13.60%	14.10%	15.10%
Tier I Risk-Based Capital/Risk-Adjusted Assets	10.94%	11.94%	12.44%	12.94%	13.94%
Tier I Leverage Capital/Average Total Assets	9.92%	10.83%	11.28%	11.74%	12.64%
<i>Total Capital/Average Total Assets</i>	<i>10.98%</i>	<i>11.89%</i>	<i>12.34%</i>	<i>12.80%</i>	<i>13.71%</i>

## Warrants Required

Total Value to be added to Capital	\$	1,253	\$	1,879	\$	2,505	\$	3,758
# of shs using \$11.11 per share	\$	10.52		119,112		178,668		238,224
% dilution				2.13%		3.19%		4.25%
								6.38%