

TO OUR SHAREHOLDERS

In our letter to shareholders a year ago, we celebrated the opening of a new corporate headquarters and business banking office in Del Mar Heights and outlined a strategy for the growth of First Business Bank. While we achieved many of our milestones in 2008, we need to acknowledge that the banking industry reached a tipping point worldwide last year and we were not immune from the fallout. The freezing up of the credit system, as-yet unsuccessful attempts by governments to recapitalize the banking system, forced bank mergers and dissolutions, and government takeovers of Fannie Mae and Freddie Mac put an end to “business-as-usual” and made it extremely difficult for most banks to make a profit.

In our case, First Business Bank had been an SBA Preferred Lender and originated guaranteed loans under the SBA 7(a) program in 2006 and 2007. In 2008, the combination of a declining real estate market and a deteriorating economy forced us to write down \$1.2 million of these loans, which contributed to most of the \$5.8 million loss we reported last year. We have made the decision to exit the SBA 7(a) market, and while there is a possibility that some portion of these loan losses could be recovered in the future, the magnitude of the loss is extremely disappointing to everyone associated with the bank.

Fortunately, when the bank was recapitalized in 2006 your Board of Directors anticipated that ample capital would be required to put the bank on a long-term success trajectory. In spite of the losses last year we remain one of the strongest banks in our market relative to our leverage and Tier 1 Capital. At December 31, 2008, our Total Capital to Risk-Weighted Assets ratio was 22.92% compared to a 10% level required to be a “well-capitalized” bank; our Tier 1 Capital ratio was 21.63% compared to a 6% ratio required to be “well-capitalized.” This high level of capitalization will allow us to pursue opportunities to grow in 2009 while other banks struggle to find adequate capital to operate.

In addition, the bank’s assets reached \$99.3 million by year-end, an increase of nearly 26% over \$72.9 million in assets at the end of 2007. Loans increased 65%, from \$46.6 million to \$77.1 million, and deposits grew to \$72.8 million, up 48% from last year’s \$49.3 million.

Partly underpinning this growth has been the expansion of our branch system. In addition to adding Del Mar Heights in February, we opened a loan/deposit production office in Carlsbad in September. Deposits at that location grew rapidly and reached \$8 million by the end of the year. Effective February 7, 2009, we transferred full-service branch status from La Mesa to Carlsbad and closed the La Mesa office. Together, the Carlsbad and Del Mar locations put us in an excellent position to establish our brand identity throughout San Diego’s growing North County coastal business and professional community.

While it is impossible to predict the course of the economy this year, or how quickly or effectively government policy will restore stability and confidence to the financial system, we have committed to three goals for 2009:

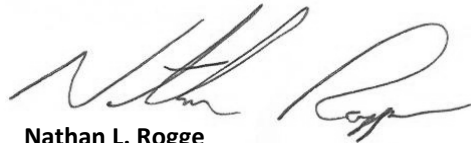
- Continue to grow our core business
- Contain our credit losses
- Solidify our team

We truly believe we have put together one of the strongest banking teams in San Diego. Our staff is dedicated to providing the best possible customer service. Our loan department is staffed by experienced professionals who know how to serve clients and grow the bank's assets while taking appropriate risks.

Like all financial companies, First Business Bank is dealing with difficult times, but we are optimistic because we know we have built a good company with a solid business model serving one of the best markets in America. We thank you for your continued confidence and support.



John Farkash
Chairman of the Board of Directors



Nathan L. Rogge
President and Chief Executive Officer



Vavrinek, Trine, Day & Co., LLP
Certified Public Accountants & Consultants

VALUE THE DIFFERENCE

INDEPENDENT AUDITORS' REPORT

Board of Directors
First Business Bank, N.A.
Del Mar, CA

We have audited the accompanying statements of financial condition of First Business Bank, N.A. as of December 31, 2008 and 2007, and the related statements of operations, shareholders' equity, and cash flows for the years then ended. These financial statements are the responsibility of the Bank's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of First Business Bank, N.A. as of December 31, 2008 and 2007 and the results of its operations and its cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Vavrinek, Trine, Day & Co., LLP

Laguna Hills, California
April 10, 2009

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FIRST BUSINESS BANK, N.A.

STATEMENTS OF FINANCIAL CONDITION

December 31, 2008 and 2007

	2008	2007
Assets		
Cash and Due from Banks	\$ 2,688,359	\$ 1,029,992
Federal Funds Sold	5,021,302	8,051,889
Total Cash and Cash Equivalents	7,709,661	9,081,881
Investment Securities Available for Sale	12,703,713	11,759,020
Interest-Bearing Time Deposits in Financial Institutions	771,805	2,503,217
Stock Investments, at Cost	1,048,600	959,250
Loans Held for Sale	-	1,050,517
Loans:		
Construction and Land Development	8,772,931	3,138,731
Real Estate - Other	51,653,386	30,692,412
Commercial	15,606,660	11,846,109
Consumer	1,012,331	930,178
Total Loans	77,045,308	46,607,430
Deferred Loan Fees and Discounts, Net of Costs and Premiums	(92,690)	(164,973)
Discount on SBA Loans	(55,783)	(98,395)
Allowance for Loan Losses	(2,336,887)	(676,017)
Net Loans	74,559,948	45,668,045
Premises and Equipment	1,050,845	1,159,745
Accrued Interest and Other Assets	1,481,873	812,227
Total Assets	\$ 99,326,445	\$ 72,993,902

The accompanying notes are an integral part of these financial statements.

FIRST BUSINESS BANK, N.A.

STATEMENTS OF FINANCIAL CONDITION

December 31, 2008 and 2007

	2008	2007
Liabilities and Shareholders' Equity		
Deposits:		
Noninterest-Bearing Demand	\$ 11,695,417	\$ 8,405,730
Interest-Bearing Demand, Money Market and Savings Accounts	32,181,548	31,616,252
Time Deposits Under \$100,000	13,364,292	3,169,708
Time Deposits \$100,000 and Over	15,567,046	6,181,715
Total Deposits	72,808,303	49,373,405
Federal Home Loan Bank Advances	7,000,000	-
Reserve for Off-Balance Sheet Credit Exposure	1,250,643	30,000
Accrued Interest and Other Liabilities	1,120,077	953,673
Total Liabilities	82,179,023	50,357,078
Commitments and Contingencies - Notes E & K	-	-
Shareholders' Equity:		
Common Stock - 10,000,000 Shares Authorized, \$5.00 Par Value;		
Issued and Outstanding 2,643,534 in 2008 and 2,642,534 in 2007	13,217,670	13,212,670
Additional Paid-in Capital	13,375,905	13,256,476
Accumulated Deficit	(9,696,784)	(3,904,775)
Accumulated Other Comprehensive Income - Unrealized Gain		
(Loss) on Available-for-Sale Securities	250,631	72,453
Total Shareholders' Equity	17,147,422	22,636,824
Total Liabilities and Shareholders' Equity	\$ 99,326,445	\$ 72,993,902

The accompanying notes are an integral part of these financial statements.

FIRST BUSINESS BANK, N.A.

STATEMENTS OF OPERATIONS

December 31, 2008 and 2007

	2008	2007
Interest Income		
Interest and Fees on Loans	\$ 4,021,292	\$ 3,621,949
Investment Securities:		
Interest Income	607,329	415,559
Dividends	60,670	55,002
Interest on Federal Funds Sold	154,191	499,130
Interest on Time Deposits in Financial Institutions	71,698	321,320
Total Interest Income	4,915,180	4,912,960
Interest Expense		
Interest on Savings, NOW and Money Market Accounts	631,356	1,092,138
Interest on Time Deposits	660,038	326,118
Interest on FHLB Advances	9,701	-
Total Interest Expense	1,301,095	1,418,256
Net Interest Income	3,614,085	3,494,704
Provision for Loan Losses	2,840,817	-
Net Interest Income After Provision for Loan Losses	773,268	3,494,704
Noninterest Income		
Gain on Sale of Loans	47,090	294,909
Loan Referral Fees	10,000	274,138
Service Charges, Fees and Other	254,161	241,905
Write-down of Other Real Estate Owned	(105,336)	-
Loss on Sale of Premises	(71,285)	(7,979)
	134,630	802,973
Noninterest Expense		
Salaries and Employee Benefits	2,982,776	2,613,124
Occupancy and Equipment Expenses	1,041,037	499,895
Provision for Off-Balance Sheet Credit Exposure	1,220,643	-
Other Expenses	1,454,651	1,452,532
	6,699,107	4,565,551
Loss Before Income Taxes	(5,791,209)	(267,874)
Income Taxes	800	800
Net Loss	\$(5,792,009)	\$(268,674)
Net Loss Per Share - Basic	\$(2.19)	\$(0.10)

The accompanying notes are an integral part of these financial statements.

FIRST BUSINESS BANK, N.A.

STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

December 31, 2008 and 2007

	Shares Outstanding	Common Stock	Additional Paid-in Capital	Comprehensive Income	Accumulated Deficit	Accumulated Other Comprehensive Income	Total
Balance at January 1, 2007	2,641,534	\$ 13,207,670	\$ 13,157,036		\$ (3,636,101)	\$ (12,290)	\$ 22,716,315
Exercise of Stock Options	1,000	5,000	5,000				10,000
Stock-Based Compensation			94,440				94,440
Comprehensive Income:							
Net Loss				\$(268,674)	(268,674)		(268,674)
Unrealized Gain on Available-for-Sale Securities				84,743		84,743	84,743
Total Comprehensive Income				\$(183,931)			
Balance at December 31, 2007	2,642,534	13,212,670	13,256,476		(3,904,775)	72,453	22,636,824
Exercise of Stock Options	1,000	5,000	5,000				10,000
Stock Based Compensation			114,429				114,429
Comprehensive Income:							
Net Loss				\$(5,792,009)	(5,792,009)		(5,792,009)
Unrealized Gain on Available-for-Sale Securities				178,178		178,178	178,178
Total Comprehensive Income				\$(5,613,831)			
Balance at December 31, 2008	2,643,534	\$ 13,217,670	\$ 13,375,905		(\$ 9,696,784)	\$ 250,631	\$ 17,147,422

The accompanying notes are an integral part of these financial statements.

FIRST BUSINESS BANK, N.A.

STATEMENTS OF CASH FLOWS

December 31, 2008 and 2007

	2008	2007
Operating Activities		
Net Loss	\$(5,792,009)	\$(268,674)
Adjustments to Reconcile Net Loss to Net Cash Provided (Used) by Operating Activities:		
Depreciation and Amortization	302,309	152,655
Gain on Sale of SBA loans	(47,090)	(294,909)
Provision for Loan Losses	2,840,817	-
Provision for Loss on Off-Balance Sheet Credit Exposure	1,220,643	-
Provision for loss on OREO	105,336	-
Stock-Based Compensation	114,429	94,440
Amortization of Net Premiums on Investments	2,208	4,019
Amortization of Servicing Assets	38,466	14,538
Increase in Valuation Allowance on Servicing Assets	4,513	-
Accretion of loan discounts and deferred interest, net of loan origination costs and fees deferred	(76,073)	(106,702)
FHLB Stock Dividends paid in FHLB Stock	(14,000)	(8,300)
Loss on Disposal of Premises and Equipment	71,285	7,979
Proceeds from Sale of Loans	788,920	5,742,840
Loans Originated for Sale	-	(1,051,993)
Increase in Other Assets	(213,853)	(106,394)
Increase in Other Liabilities	183,825	204,568
Net Cash Provided (Used) By		
Operating Activities	(470,274)	4,384,067
Investing Activities		
Purchase of Available-for-Sale Securities	(4,681,794)	(8,374,413)
Purchase of Loans Held for Investment	(12,777,524)	(500,000)
Net Maturity of Time Deposits in Financial Institutions	1,731,412	10,434,550
Proceeds from Maturities of Available-for-Sale Securities	3,913,070	4,320,378
Net Funding of Loans	(19,191,964)	(18,310,528)
Net Purchase of Federal Home Loan and Federal Reserve Bank Stock	(75,350)	(72,500)
Purchases of Premises and Equipment, net of Sales Proceeds	(264,694)	(642,646)
Net Cash Used By		
Investing Activities	(31,346,844)	(13,145,159)

The accompanying notes are an integral part of these financial statements.

FIRST BUSINESS BANK, N.A.

STATEMENTS OF CASH FLOWS - CONTINUED

December 31, 2008 and 2007

	2008	2007
Financing Activities		
Net Increase in Demand, MMDA and Savings accounts	3,854,983	6,649,160
Net Increase in Time Deposits	19,579,915	716,046
Net increase in Federal Home Loan Bank Advances	7,000,000	-
Proceeds from Exercise of Stock Options	10,000	10,000
Net Cash Provided By Financing Activities	30,444,898	7,375,206
Increase (Decrease) in Cash and Cash Equivalents	(1,372,220)	(1,385,886)
Cash and Cash Equivalents at Beginning of Period	9,081,881	10,467,767
Cash and Cash Equivalents At End Of Year	\$ 7,709,661	\$ 9,081,881
Supplemental Disclosures of Cash Flow Information:		
Interest Paid	\$ 1,381,136	\$ 1,429,241
Taxes Paid	800	800
Loans transferred from Held for Investment to Held for Sale	618,501	5,401,554
Loans transferred from Held for Sale to Held for Investment	884,734	-
Loans transferred from Held for Investment to OREO	595,759	-
Leasehold Improvements Paid for by the Landlord	-	323,500
Change in unrealized Gain (Loss) on AFS Investments, net of change in Income Tax of \$0 and \$8,191, recorded in AOCI	\$ 178,178	\$ 84,743

The accompanying notes are an integral part of these financial statements.

FIRST BUSINESS BANK, N.A.

NOTES TO FINANCIAL STATEMENTS

December 31, 2008 and 2007

Note A – Summary of Significant Accounting Policies

Nature of Operations

First Business Bank, N.A. began business operations in December 2001 under the name Ramona National Bank. The name was changed in late 2006. The Bank operates under a federal charter and its primary regulator is the Office of the Comptroller of the Currency (“OCC”). First Business Bank is organized as a single operating segment that operates three full-service offices in Del Mar Heights, Carlsbad, and Ramona, California. The Bank’s primary source of revenue is providing loans to clients, who are predominately small and middle-market businesses and individuals. Client deposits are insured by the Federal Deposit Insurance Corporation (“FDIC”) up to the maximum legal limit and the Bank is a member of the Federal Reserve Bank (“FRB”).

Use of Estimates in the Preparation of Financial Statements

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Reclassifications

Certain amounts in the 2007 financial statements have been reclassified to conform to the 2008 presentation. The reclassifications have no effect on net loss or shareholders’ equity as previously reported.

Cash and Cash Equivalents

For purposes of reporting cash flows, cash and cash equivalents include cash and due from banks, and federal funds sold. Generally, federal funds are sold for one-day periods.

Cash and Due from Banks

Banking regulations require that banks maintain a percentage of their deposits as reserves in cash or on deposit with the Federal Reserve Bank. The Bank’s reserve requirement at December 31, 2008 was \$59,000, which was met through the Bank’s cash reserves. The Bank’s net transaction accounts were below the reserve exemption level at December 31, 2007, and the Bank had no reserve requirement at that date.

The Bank maintains amounts due from banks, which may exceed federally insured limits. The Bank has not experienced any losses in such accounts.

Interest-Bearing Time Deposits in Financial Institutions

The Bank invests in time certificates of deposit at other financial institutions. The latest maturity of any of these deposits is July 2009.

FIRST BUSINESS BANK, N.A.

Note A – Summary of Significant Accounting Policies (Continued)

Investment Securities

Investment securities are classified as held-to-maturity when the Bank has the positive intent and ability to hold the securities to maturity. Securities held-to-maturity is carried at amortized cost. The amortization of premiums and accretion of discounts are recognized in interest income using methods approximating the interest method over the period to maturity.

Investments not classified as trading securities nor as held-to-maturity securities are classified as available-for-sale securities and recorded at fair value. Unrealized gains or losses on available-for-sale securities are excluded from net income and reported as an amount net of taxes as a separate component of other comprehensive income included in shareholders' equity. Premiums or discounts on held-to-maturity and available-for-sale securities are amortized or accreted into income using the interest method. Realized gains or losses on sales of held-to-maturity or available-for-sale securities are recorded using the specific identification method.

Declines in the fair value of individual held-to-maturity and available-for-sale securities below their cost that are other-than-temporary result in write-downs of the individual securities to their fair value. The related write-downs are included in earnings as realized losses. In estimating other-than-temporary impairment losses, management considers; the length of time and the extent to which the fair value has been less than cost, the financial condition and near-term prospects of the issuer, and the intent and ability of the Bank to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value.

Stock Investments

Federal Reserve Bank stock, Federal Home Loan Bank stock and Pacific Coast Bankers' Bank stock are carried at cost. These stocks can only be sold back to the issuing institution at par value or book value. All stock investments are evaluated for impairment based on an estimate of the ultimate recoverability of cost.

Loans

Loans receivable that management has the intent and ability to hold for the foreseeable future or until maturity or payoff are reported at their outstanding unpaid principal balances reduced by any charge-offs and net of any deferred fees or costs on originated loans, or unamortized premiums or discounts on purchased loans. Loan origination fees and certain direct origination costs are capitalized and recognized as an adjustment of the yield of the related loan. Amortization of deferred loan fees is discontinued when a loan is placed on nonaccrual status.

Loans originated and intended for sale in the secondary market are carried at the lower of cost or estimated fair value in the aggregate. Fair value is based on commitments on hand from investors or prevailing market prices. Net unrealized losses, if any, are recognized through a valuation allowance by charges to income. The Bank is a Small Business Administration (SBA) lender and will sell the guaranteed portion of the loan in the secondary market. SBA guaranteed loans are classified as Held for Sale when the loan is fully funded and other conditions required for salability have been met.

Loans on which the accrual of interest has been discontinued are designated as nonaccrual loans. The accrual of interest on loans is generally discontinued when principal or interest is past due 90 days based on the contractual terms of the loan or earlier when, in the opinion of management, there is reasonable doubt as to collectability. On a case by case basis, loans past due 90 days may remain on accrual, if the loan is well collateralized, actively in process of collection and, in the opinion of management, likely to be paid current within the next payment cycle. When loans are placed on nonaccrual status, all interest previously accrued but not collected is reversed against current period interest income. Income on nonaccrual loans is subsequently recognized only to the extent that

FIRST BUSINESS BANK, N.A.

Note A – Summary of Significant Accounting Policies (Continued)

Loans (Continued)

cash is received and the loan's principal balance is deemed collectible. Interest accruals are resumed on such loans only when they are brought current with respect to interest and principal and when, in the judgment of management, the loans are estimated to be fully collectable as to all principal and interest.

The Bank considers a loan to be impaired when it is probable that the Bank will be unable to collect all amounts due (principal and interest) according to the contractual terms of the loan agreement. Measurement of impairment is based on the expected future cash flows of an impaired loan, which are to be discounted at the loan's effective interest rate, or measured by reference to an observable market value, if one exists, or the fair value of the collateral for a collateral-dependent loan. The Bank selects the measurement method on a loan-by-loan basis except that collateral-dependent loans for which foreclosure is probable are measured at the net realizable value of the collateral. The Bank recognizes interest income on impaired loans based on its existing methods of recognizing interest income on nonaccrual loans.

Allowance for Loan Losses

The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. Loan losses are charged against the allowance when management believes the loan is uncollectible. Subsequent recoveries, if any, are credited to the allowance.

The allowance for loan losses is evaluated on a regular basis by management and is based upon management's periodic review of the collectability of the loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral, and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

Other Real Estate Owned

Real estate acquired through foreclosure is reclassified from the loan portfolio when legal title is transferred. The real estate owned is reclassified at the lower of the recorded investment in the loan or the net realizable value of the property. Net realizable value is measured as the expected sales price, less the expected expense associated with the sale. Write downs to net realizable value when title is acquired are charged against the allowance for loan loss. Subsequent declines in the net realizable value after title is acquired are recorded as a valuation allowance against the property and charged to expense. Major improvements to the property may be capitalized to the basis in the property, provided the increase to the recorded investment does not exceed the net realizable value.

In 2008, the Bank acquired title to a commercial property through foreclosure of an SBA guaranteed loan. The real estate market in the area is severely depressed and offers received after listing the property for sale indicated the Bank's interest in the net realizable value was immaterial. The Bank has recorded a 100% valuation allowance of \$105,336 and the property remains for sale. The Bank has made demand for the SBA guaranteed portion of the loan and carries a receivable from the SBA in other assets of \$490,000.

Transfers of Financial Assets

Transfers of financial assets are accounted for as sales, when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when; (1) the assets have been isolated from the Bank, (2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and (3) the Bank does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.

FIRST BUSINESS BANK, N.A.

Note A – Summary of Significant Accounting Policies (Continued)

Servicing Assets

Servicing assets are recognized as separate assets when rights are acquired through the sale of financial assets. Capitalized servicing rights are reported in other assets and are amortized into other income in proportion to, and over the period of, the estimated future net servicing income of the underlying financial assets. Servicing assets are evaluated for impairment based upon the fair value of the rights as compared to amortized cost. Impairment is determined by stratifying rights by predominant characteristics, such as interest rates and terms. Fair value is determined using prices for similar assets with similar characteristics, when available, or based upon discounted cash flows using market-based assumptions. Impairment is recognized through a valuation allowance for an individual stratum, to the extent that fair value is less than the capitalized amount for the stratum.

Gain on Sale of Loan

The Bank accounts for the sale of SBA guaranteed portions following Statement of Financial Accounting Standard (“SFAS”) No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*, as amended by SFAS No. 156, *Accounting for Servicing of Financial Assets*. The recorded investment in the guaranteed and unguaranteed portion of the loan, and separately identifiable servicing assets, is reallocated based on the relative fair values of each component. Accounting gain on sale is recognized to the extent the fair value of the assets sold and the servicing asset created exceed the reallocated recorded investment. Servicing assets are initially recorded at fair value. This reallocation of basis results in an accounting gain that is less than the cash premium received with the sale. The difference is recorded as a discount on the unguaranteed portion of the loan retained. The discount is accreted to income over the remaining life of the loan following the interest method.

Loan Referrals

The Bank may elect to refer loan clients to other lending institutions rather than close the transaction itself. These institutions will fund the loan directly and pay the Bank a referral fee for the transaction. The Bank has no credit recourse on these transactions. Limited recourse exists on the fee received, generally contingent on the loan’s performance for ninety days after the transaction. Referral fees are recognized as earned in the period received. In 2008 the Bank referred loan transactions for \$800,000 in total principle balance for \$10,000 in referral fees. In 2007, the Bank referred loan transactions for \$5,330,000 in total principal balance to third party lenders for \$274,138 in referral fees.

Premises and Equipment

Premises and equipment are carried at cost less accumulated depreciation and amortization. Depreciation is computed using the straight-line method over the estimated useful lives, which ranges from three to seven years for furniture, equipment and computer equipment. Leasehold improvements are amortized using the straight-line method over the estimated useful lives of the improvements or the remaining lease term, whichever is shorter. Expenditures for betterments or major repairs are capitalized and those for ordinary repairs and maintenance are charged to operations as incurred.

Advertising Costs

The Bank expenses the costs of advertising in the period incurred.

FIRST BUSINESS BANK, N.A.

Note A – Summary of Significant Accounting Policies (Continued)

Income Taxes

Deferred income taxes are computed using the asset and liability method, which recognizes a liability or asset representing the tax effects, based on current tax law, of future deductible or taxable amounts attributable to events that have been recognized in the consolidated financial statements. A valuation allowance is established to reduce the deferred tax asset to the level at which it is “more likely than not” that the tax asset or benefits will be realized. Realization of tax benefits of deductible temporary differences and operating loss carryforwards depends on having sufficient taxable income of an appropriate character within the carryforward periods.

The Bank has adopted Financial Accounting Standards Interpretation No. 48 (“Fin 48”), “*Accounting for Uncertainty in Income Taxes*.” Fin 48 clarifies the accounting for uncertainty in tax positions taken or expected to be taken on a tax return and provides that the tax effects from an uncertain tax position can be recognized in the financial statements only if, based on its merits, the position is more likely than not to be sustained on audit by the taxing authorities. Management believes that all tax positions taken to date are highly certain and, accordingly, no accounting adjustment has been made to the financial statements. Interest and penalties related to uncertain tax positions are recorded as part of income tax expense.

Comprehensive Income

Statement of Financial Accounting Standard No. 130, “*Reporting Comprehensive Income*,” requires the disclosure of comprehensive income and its components. Changes in unrealized gain and loss on available-for-sale securities are the only components of accumulated other comprehensive income for the Bank.

Financial Instruments

In the ordinary course of business, the Bank has entered into off-balance sheet financial instruments consisting of commitments to extend credit, commercial letters of credit, and standby letters of credit as described in Note K. The Bank is a contingent obligor under a letter of credit issued on its behalf by another financial institution. Such financial instruments are recorded in the financial statements when they are funded or related fees are incurred or received.

Disclosure about Fair Value of Financial Instruments

Other than the Bank’s investment securities and SBA guaranteed loans, no active market exists for the Bank’s financial instruments. The fair market value of investment securities are discussed in Note B. Management believes the fair market value of its other financial instruments, primarily loans and deposits, approximates the amounts reported in the financial statements and notes.

Earnings Per Share (EPS)

Basic EPS excludes dilution and is computed by dividing income available to common stockholders by the weighted-average number of common shares outstanding for the period. Diluted EPS reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock or resulted in the issuance of common stock that then shared in the earnings of the entity. The Bank had no dilutive securities as of December 31, 2008 and 2007 as well as an operating loss and therefore only reports basic EPS. Weighted average shares outstanding used in the computation of basic earnings per share were 2,642,783 and 2,642,013 in 2008 and 2007, respectively.

FIRST BUSINESS BANK, N.A.

Note A – Summary of Significant Accounting Policies (Continued)

Stock-Based Compensation

The Bank adopted SFAS No. 123(R) “*Share-Based Payment*” effective January 1, 2006 following the modified prospective method. This Statement generally requires entities to recognize the cost of employee services received in exchange for awards of stock options, or other equity instruments, based on the grant-date fair value of those awards. This cost is recognized over the period which an employee is required to provide services in exchange for the award, generally the vesting period.

Fair Value Measurement

Effective January 1, 2008, the Bank adopted SFAS No. 157, *Fair Value Measurements*. This Statement defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. This Statement establishes a fair value hierarchy about the assumptions used to measure fair value and clarifies assumptions about risk and the effect of a restriction on the sale or use of an asset. The impact of adoption of SFAS No. 157 is not material. Applicable disclosures are presented in these financial statements.

In February 2008, the FASB issued Staff Position (FSP) 157-2, *Effective Date of FASB Statement No. 157*. This FSP delays the effective date of SFAS 157 for all non-financial assets and non-financial liabilities, except those that are recognized or disclosed at fair value on a recurring basis (at least annually) for fiscal years beginning after November 15, 2008.

In February 2007, the FASB issued Statement 159, *The Fair Value Option for Financial Assets and Financial Liabilities*. The standard provides companies with an option to report selected financial assets and liabilities at fair value and establishes presentation and disclosure requirements designed to facilitate comparisons between companies that choose different measurement attributes for similar types of assets and liabilities. The new standard was effective for the Bank on January 1, 2008. The Bank did not elect the fair value option for any financial assets or financial liabilities as of January 1, 2008.

Statement 157 defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. Statement 157 also establishes a fair value hierarchy, which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The standard describes three levels of inputs that may be used to measure fair value:

Level 1: Quoted prices (unadjusted) for identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.

Level 2: Significant other observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data.

Level 3: Significant unobservable inputs that reflect a Bank’s own assumptions about the assumptions that market participants would use in pricing an asset or liability.

See Note N for more information and disclosures relating to the Bank’s fair value measurements.

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Note B – Investment Securities

Debt and equity securities have been classified in the statements of condition according to management's intent. The carrying amount of securities and their approximate fair values at December 31 were as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available-for-Sale:				
December 31, 2008				
U.S. Government and Agency Securities	\$ 5,719,969	\$ 116,998	\$ -	\$ 5,836,967
Mortgage-Backed Securities	6,733,113	137,428	(3,795)	6,866,746
	<u>\$ 12,453,082</u>	<u>\$ 254,426</u>	<u>\$(3,795)</u>	<u>\$ 12,703,713</u>
Available-for-Sale:				
December 31, 2007				
U.S. Government and Agency Securities	\$ 5,995,935	\$ 44,247	\$(6,300)	\$ 6,033,882
Mortgage-Backed Securities	5,690,632	40,641	(6,135)	5,725,138
	<u>\$ 11,686,567</u>	<u>\$ 84,888</u>	<u>\$(12,435)</u>	<u>\$ 11,759,020</u>

The amortized cost and estimated fair value of all investment securities as of December 31, 2008 by contractual maturities are shown below. Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	Available-for-Sale	
	Amortized Cost	Fair Value
Due in One Year or Less	\$ 2,542,021	\$ 2,615,674
Due from One Year to Five Years	2,125,503	2,145,446
Due from Five to Ten Years	3,989,282	4,059,364
Due after Ten Years	3,796,276	3,883,229
	<u>\$ 12,453,082</u>	<u>\$ 12,703,713</u>

There were no sales of investment securities in 2008 or 2007.

The Bank will pledge investment securities to collateralize credit lines, secure public deposits, and for other purposes as permitted or required by law. Investment securities carried at \$4,782,000 and \$6,790,000 at December 31, 2008 and 2007, respectively, were in safekeeping at the Federal Home Loan Bank (FHLB) of San Francisco to collateralize credit lines there. Investment securities carried at \$2,528,525 at December 31, 2007 were pledged against a purchased federal funds line with a correspondent bank. In 2008 the collateral requirements on this line were removed and the Bank had no securities pledged on this line at December 31, 2008.

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Note B – Investment Securities (Continued)

The gross unrealized loss and related estimated fair value of investment securities that have been in a continuous loss position for less than twelve months and over twelve months at December 31, 2008 and 2007 are as follows:

	Less than Twelve Months		Over Twelve Months		Total	
	Unrealized		Unrealized		Unrealized	
	Losses	Fair Value	Losses	Fair Value	losses	Fair Value
December 31, 2008:						
Mortgage-Backed Securities	\$(2,350)	\$ 909,358	\$(1,445)	\$ 172,444	\$(3,795)	\$ 1,081,802
	\$(2,350)	\$ 909,358	\$(1,445)	\$ 172,444	\$(3,795)	\$ 1,081,802
December 31, 2007:						
U.S. Government and Agency Securities	\$(2,408)	\$ 1,497,892	\$(3,892)	\$ 493,530	\$(6,300)	\$ 1,991,422
Mortgage-Backed Securities	-	-	(6,135)	245,411	(6,135)	245,411
	\$(2,408)	\$ 1,497,892	\$(10,027)	\$ 738,941	\$(12,435)	\$ 2,236,833

As of December 31, 2008, the Bank had five Mortgage-Backed securities that had declined 0.35% from amortized cost. Management evaluates investment securities for other-than-temporary impairment taking into consideration the extent and length of time the fair value has been less than cost, the financial condition of the issuer and whether the Bank has the intent and ability to retain the investment for a period of time sufficient to allow for any anticipated recovery in fair value, which may be at maturity. As of December 31, 2008, no declines in value are deemed to be other-than-temporary.

Note C – Stock Investments, at Cost

As a member of the FRB System, the Bank must hold FRB stock in an amount equal to 6% of the Bank's common stock and additional paid-in capital, less accumulated deficit. Stock in the FHLB of San Francisco is required for membership. The Bank is required to maintain an investment in FHLB stock in an amount equal to the greater of 1% of its outstanding mortgage loans or 4.7% of advances from the FHLB. The Bank had \$7,000,000 in FHLB advances outstanding at December 31, 2008 and no advances outstanding at December 31, 2007. No ready market exists for FHLB stock, and it has no quoted market value.

The table below summarizes the Bank's stock investments at December 31:

	2008	2007
Federal Reserve Bank	\$ 639,500	\$ 682,950
Federal Home Loan Bank	349,100	216,300
Pacific Coast Bankers Bank	60,000	60,000
	\$ 1,048,600	\$ 959,250

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Note D - Loans

The Bank's loan portfolio consists primarily of loans to borrowers within San Diego County, California. Although the Bank seeks to avoid concentrations of loans to a single industry or based upon a single class of collateral, real estate and real estate associated businesses are among the principal industries in the Bank's market area. The Bank's loan portfolio concentration in real estate secured credit at December 31, 2008 was 78%.

The Bank's total servicing portfolio of sold guaranteed loans was \$5,748,779 at December 31, 2008 and \$6,532,061 at December 31, 2007. The recorded investment in servicing assets related to this portfolio was \$25,673 and \$60,303 at December 31, 2008 and 2007, respectively. A substantial portion of the Bank's SBA servicing portfolio is nonperforming as of December 31, 2008. The Bank recognized impairment of \$4,513 on servicing assets in 2008 and carried an impairment allowance in that amount at December 31, 2008. The impairment was charged against servicing fee income. The Bank had no impairment charge in 2007, nor an impairment allowance for servicing assets at December 31, 2007.

The Bank has pledged loans with a carrying value of \$24,982,869 to collateralize credit lines at the FHLB of San Francisco as of December 31, 2008.

A summary of the changes in the allowance for loan losses as of December 31 follows:

	2008	2007
Beginning Balance	\$ 676,017	\$ 1,088,905
Additions to the Allowance Charged to Expense	2,840,817	-
Recoveries on Loans Charged Off	33,805	787
	3,550,639	1,089,692
Less Loans Charged Off	(1,213,752)	(413,675)
Ending Balance	\$ 2,336,887	\$ 676,017

Below is a summary the Bank's recorded investment in impaired loans outstanding at December 31, 2008 and 2007.

	2008	2007
Impaired Loans with a Valuation Allowance	\$ 684,649	\$ 1,024,389
Impaired Loans without a Valuation Allowance	547,856	-
Total Impaired and Nonaccrual Loans	<u>\$ 1,232,505</u>	<u>\$ 1,024,389</u>
Corresponding valuation allowance	<u>\$ 267,402</u>	<u>\$ 82,838</u>

No additional funds are committed to be advanced on impaired loans. The average recorded investment in impaired loans was \$733,592 and \$1,030,684 in 2008 and 2007, respectively. The Bank recognized no interest income on impaired loans in 2008 and \$102,924 in interest income on impaired loans in 2007. Interest foregone on impaired loans was \$87,260 in 2008 and \$54,436 in 2007. At December 31, 2008, \$391,407 in principal balance of impaired loans was guaranteed by the SBA, and \$610,199 of the principal balance of impaired loans was guaranteed by the SBA at December 31, 2007.

At December 31, 2008 the Bank had two loans for a total recorded investment of \$618,627 that were over 90 days past due and still on accrual. The Bank had no loans in this status at December 31, 2007.

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Note D – Loans (Continued)

In addition to servicing sold SBA guaranteed loans, the Bank also services construction loans and commercial lines of credit for participating institutions. The total portfolio of loans serviced for other institutions was \$1,544,837 at December 31, 2008 and \$2,473,778 at December 31, 2007.

Note E – Premises and Equipment

A summary of premises and equipment as of December 31 follows:

	2008	2007
Leasehold Improvements	\$ 816,432	\$ 1,006,939
Furniture, Fixtures, and Equipment	670,995	529,857
Computer Equipment	298,570	266,292
	1,785,997	1,803,088
Less Accumulated Depreciation and Amortization	(735,152)	(643,343)
	\$ 1,050,845	\$ 1,159,745

Depreciation expense recorded in 2008 and 2007 was \$302,309 and \$152,655, respectively.

The Bank leases its Ramona banking premises from its principal shareholder, under a lease expiring on August 31, 2010. The Bank obtained three independent appraisals regarding the fair market rent, which supports its determination that the terms of the lease are no less favorable to the Bank than could have been obtained from unaffiliated third parties. The Ramona branch lease has two five year renewal options. Monthly lease payments are adjusted annually based on changes in the Consumer Price Index (CPI).

The Bank leased its La Mesa location from an affiliate of its principal shareholder. In December 2008, the Bank terminated this lease 14 months early and made a termination payment called for in the lease of \$80,363. The tenant improvements and certain equipment were transferred to the landlord at a loss of \$71,285. The Bank made a short-term lease with the same landlord for forty-five days ending February 15, 2009 and closed the La Mesa location effective February 6, 2009.

The Bank has a ten-year lease for its main banking office and corporate headquarters in Del Mar Heights, California, with an independent landlord. The Bank took occupancy in January 2008. Total expenditures for tenant improvements, equipment and furnishings at the Del Mar Heights location were \$949,000, including \$2,390 in interest capitalized at the Bank's cost of funds. The Bank is responsible for common area maintenance, taxes and insurance to the extent they exceed the 2008 base year amounts. The lease expires on December 31, 2017. Monthly lease payments are subject to a fixed 3.5% increase on an annual basis. The lease has one renewal option for a period of five years. A third party correspondent bank issued a performance letter of credit for \$775,000 to the landlord on behalf of the Bank to support the Bank's obligations under the lease. The lease allows for annual reductions in the amount of the letter of credit after three years and eliminates the letter of credit entirely after nine years.

The Bank opened a deposit production office in Carlsbad, California in September 2008. The office was leased for a six month term. The Bank is responsible for common area operating expenses. In February 2009, the office was upgraded to a full service branch. The lease term for this branch was extended through September 2009.

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Note E – Premises and Equipment (Continued)

At December 31, 2008, the future lease rentals payable under noncancellable operating lease commitments to related parties and others are as follows:

	Related	Others
2009	\$ 71,507	\$ 330,025
2010	41,242	332,042
2011	-	343,679
2012	-	356,092
2013	-	368,505
Thereafter		1,608,233
Total	\$ 112,750	\$ 3,338,578

The minimum rental payments shown above are given for the existing lease obligation and are not a forecast of future rental expense. Total rental expense was \$565,090 and \$241,524 for the years ended December 31, 2008 and 2007, respectively.

Note F - Deposits

At December 31, 2008, the scheduled maturities of time deposits are as follows:

2009	\$ 18,017,201
2010	1,254,800
2011	1,971,416
2012	1,802,000
2013	5,885,921
	<u>\$ 28,931,338</u>

Note G – Borrowing Arrangements

The Bank may borrow up to \$6,000,000 overnight on a secured basis from The Independent Bankers Bank, and \$2,000,000 overnight on an unsecured basis from Pacific Coast Bankers Bank. The Bank had no overnight borrowings at December 31, 2008 or 2007.

The Bank may also borrow up to approximately \$13,500,000 from the Federal Home Loan Bank of San Francisco, collateralized by investment securities and liens on specific Bank loans delivered to the FHLB, and subject to fulfilling other conditions of the credit facility. At December 31, 2008 the Bank had four advances for a total of \$7,000,000 outstanding on the line. Two of the advances are fixed rate with one for \$3,000,000 bearing interest at .20% maturing January 14, 2009; and the other for \$1,000,000 at an interest rate of 1.89% maturing December 29, 2011. The other two advances are variable rate. One variable rate advance is tied to one month LIBOR, adjusts monthly and bears interest at LIBOR plus 42 basis points, which was .85625% at December 31, 2008. This advance is for \$2,000,000 and matures December 30, 2011. The other variable rate advance changes with the prime rate and bears interest at the prime rate minus 1.70%, which was 1.55% at December 31, 2008. This advance is for \$1,000,000 and matures December 31, 2013. The Bank had no FHLB advances outstanding at December 31, 2007. A Letter of Credit issued by the FHLB on the Bank's behalf for \$775,000 was outstanding under the credit facility at both December 31, 2008 and 2007.

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Note H- Income Taxes

The tax expense for the years ended December 31, 2008 and 2007 was the minimum franchise tax for the State of California. The tax benefits related to the operating losses incurred during the years ended December 31, 2008 and 2007 were not recognized, as realization of the benefits is dependent upon future income.

Deferred taxes are a result of differences between income tax accounting and generally accepted accounting principles with respect to income and expense recognition. The following is a summary of the components of the net deferred tax asset accounts recognized in the accompanying statements of financial condition at December 31:

	2008	2007
Deferred Tax Assets:		
Depreciation Differences	\$ 4,000	\$ 66,000
Allowance for Loan Losses Due to Tax Limitations	750,000	226,000
Reserve for Off-Balance Sheet Credit Exposure	515,000	12,000
Stock-Based Compensation	39,000	19,000
Operating Loss Carryforwards	2,445,000	1,248,000
Deferred Rent Expense	22,000	-
Accrual to Cash	91,000	-
Other	60,000	75,000
	<u>3,926,000</u>	<u>1,646,000</u>
 Valuation Allowance	 (3,911,000)	 (1,565,000)
Deferred Tax Liabilities:		
Deferred Loan Costs	(15,000)	(14,000)
Accrual to Cash	-	(67,000)
	<u>(15,000)</u>	<u>(81,000)</u>
Net Deferred Tax Assets	\$ -	\$ -

The valuation allowance was established because the Bank has not reported earnings sufficient enough to support the recognition of the deferred tax assets. The Bank has net operating loss carryforwards of approximately \$3,028,000 for federal income and \$3,055,000 for California franchise tax purposes. Federal net operating loss carryforwards, to the extent not used will expire in 2028. California net operating loss carryforwards, to the extent not used will expire in 2028.

The Bank is subject to federal and California franchise tax. Income tax returns for the years ended December 31, 2007, 2006 and 2005 are open to audit by the federal authorities and income tax returns for the years ended December 31, 2007, 2006, 2005, and 2004 are open to audit by California authorities. Unrecognized tax benefits are not expected to significantly increase or decrease within the next twelve months.

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Note I – Other Expenses

Other expenses as of December 31 are comprised of the following:

	2008	2007
Data Processing	\$ 329,802	\$ 330,376
Marketing and Public Relations	137,889	104,670
Professional Fees	229,524	407,152
Litigation Provision	50,000	-
Office Expenses	149,036	139,106
Insurance	30,555	39,904
Deposit Administration and Online Banking	114,745	75,425
Loan Administration	93,455	63,454
OREO Expense	21,399	-
Regulatory Assessments	101,119	109,841
Other Expenses	197,127	182,604
	<u>\$ 1,454,651</u>	<u>\$ 1,452,532</u>

Note J – Related Party Transactions

In the ordinary course of business, the Bank has granted loans to certain directors and their related interests with which they are associated. In the Bank's opinion, all loans and loan commitments to such parties are made on substantially the same terms including interest rates, and collateral, as those prevailing at the time for comparable transactions with unrelated clients. The balance of these loans outstanding was \$483,611 and \$498,585 at December 31, 2008 and 2007, respectively. Activity in related party loans for the periods ending December 31, 2008 and 2007 is below:

	2008	2007
Balance at Beginning of Year	\$ 498,585	\$ 514,938
Credit Granted, Including Renewals	60,000	68,000
Repayments	(74,974)	(84,353)
	<u>\$ 483,611</u>	<u>\$ 498,585</u>

Deposits held by the Bank from certain shareholders, directors, officers and their related interests at December 31, 2008 and 2007 amounted to \$2,285,737 and \$3,544,524, respectively.

Note K – Commitments and Contingencies

In the ordinary course of business, the Bank enters into financial commitments to meet the financing needs of its customers. These financial commitments include commitments to extend credit and standby letters of credit. Those instruments involve to varying degrees, elements of credit and interest rate risk not recognized in the Bank's financial statements.

Commitments to extend credit are agreements to lend to a client as long as there is no violation of any condition established in the contract. Since many of the commitments are expected to expire without being drawn upon, the total amounts do not necessarily represent future cash requirements. The Bank evaluates each client's credit worthiness on a case-by-case basis. The amount of collateral obtained if deemed necessary by the Bank is based

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Note K – Commitments and Contingencies (Continued)

on management's credit evaluation of the customer. The majority of the Bank's commitments to extend credit and standby letters of credit are secured by real estate.

The Bank's exposure to loan loss in the event of nonperformance on commitments to extend credit and standby letters of credit is represented by the contractual amount of those instruments. The Bank uses the same credit policies in making commitments as it does for loans reflected in the financial statements.

As of December 31, 2008 and 2007, the Bank had the following outstanding financial commitments whose contractual amount represents potential credit risk to the Bank, and potential financial obligations of the Bank:

	2008	2007
Commitments to Extend Credit	\$ 8,741,000	\$ 12,331,000
Letters of Credit issued to Clients	115,000	-
	\$ 8,856,000	\$ 12,331,000
Letters of Credit issued on behalf of the Bank	\$ 775,000	\$ 775,000

The Bank carries a reserve for off-balance sheet credit risk in other liabilities for potential losses on commitments to extend credit and potential recourse on sold loans. The balance of the reserve at December 31, 2008 was \$1,250,643 and at December 31, 2007 the balance was \$30,000. In 2008 the Bank determined through third-party review that the SBA guarantee on certain loans that were sold in the secondary market is impaired because of deficiencies in the loan origination process. The third-party review covered \$5.8 million in sold guaranteed loans, and the Bank believes approximately \$2.1 million of these guaranteed loans are subject to some degree of impairment. The Bank is contingently liable for the impairment subject to SBA review of the loan files. The range of impairment is estimated between \$925,000 and \$1,700,000. The Bank estimates that probable losses are approximately \$1,200,000 and recorded a provision for off-balance sheet credit exposures in this amount.

The Bank evaluates the loss exposure for unfunded commitments to extend credit following the same principles used for the allowance for loan losses, with consideration for experienced utilization rates on client credit lines and the inherently lower risk of unfunded commitments relative to disbursed commitments. The Bank recorded a provision of \$20,643 for potential losses on unfunded commitments in 2008, and no provision in 2007.

Letters of Credit issued on behalf of the Bank represent a potential obligation of the Bank. The Bank caused a letter of credit to be issued by a third party correspondent to its landlord at the Del Mar Heights office. Should the letter of credit be drawn upon, the Bank would be obligated to reimburse the correspondent bank. The letter of credit supports the Bank's performance under the lease.

In the ordinary course of business the Bank may be subject to legal claims by clients and other business constituents. In 2007 the Bank was served with a legal complaint by a former information technology vendor alleging breach of contract and seeking damages of approximately \$610,000. Based on the facts of the case, should the plaintiff prevail at trial, the Bank believes it reasonably possible that damages in the range of \$120,000 to \$130,000 could be awarded. The court has ordered the matter into formal mediation. The Bank recorded a provision of \$50,000 in 2008 for the resolution of this case and has engaged in settlement negotiations.

Note L – Stock Option Plan

The Bank's 2001 Stock Option Plan (the "Plan") was modified by the shareholders in April 2007. The maximum number of shares that may be awarded to eligible employees and directors was increased from 210,000 shares to 460,000 shares. Under the terms of the Plan, officers and key employees may be granted either nonqualified or incentive stock options. Directors, who are not also an officer or employee, may be granted nonqualified stock

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Note L – Stock Option Plan (Continued)

options. Stock options are generally granted at a price not less than 100% of the fair market value of the stock on the date of grant. Stock options expire no later than ten years from the date of the grant and generally vest over five years. The Plan provides for accelerated vesting if there is a change of control, as defined in the Plan. Shares issued for the exercise of stock options are made from available authorized but unissued shares. The Bank recognized stock-based compensation cost of \$114,429 and \$94,440 in 2008 and 2007, respectively.

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model. The following table provides the weighted average assumptions used in the pricing model, and the weighted average grant date fair value, for option grants made in 2008 and 2007:

	2008	2007
Expected Volatility	26.33%	24.96%
Expected Term (Years)	6.3	6.1
Expected Dividends	None	None
Risk Free Rate	3.21%	3.89%
Weighted-Average Grant Date Fair Value	\$ 3.35	\$ 3.36

Since the Bank has very limited historical stock trade volume, the expected volatility is based on an index of the historical volatility of similar banks that have a longer trading history at higher volumes. The expected term represents the estimated average period of time that the options remain outstanding. Since the Bank does not have sufficient historical data on the exercise of stock options, the expected term is based on the “simplified” method that measures the expected term as the average of the vesting period and the contractual term. The risk free rate of return reflects the grant date yield on U.S. Treasury bonds with maturities comparable to the expected term of the options.

A summary of the status of stock options that have been granted by the Bank as of December 31, 2008 and changes during 2008 is presented below:

	Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding at Beginning of Year	228,677	\$ 10.00		
Granted	83,050	\$ 10.00		
Exercised	(1,000)	\$ 10.00		
Forfeited or Expired	(40,500)	\$ 10.00		
Outstanding at End of Year	270,227	\$ 10.00	7.8 Years	None
Options Exercisable	87,076	\$ 10.00	5.8 Years	None

The intrinsic value of options exercised during the years ended December 31, 2008 and 2007 was immaterial. Cash received each year was \$10,000 and no tax benefits were realized.

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Note L – Stock Option Plan (Continued)

As of December 31, 2008, there was \$514,553 of total unrecognized compensation cost related to the outstanding stock options that will be recognized over a weighted average period of approximately 2.4 years as scheduled below:

2009	\$	148,992
2010		143,075
2011		113,793
2012		84,804
2013		23,889
	\$	<u>514,553</u>

Future levels of compensation cost recognized related to stock-based compensation awards may be impacted by new awards and/or modifications, repurchases and cancellations of existing awards. During 2007 the Bank made a special nonqualified option grant to the Chief Operating Officer for 15,000 shares. This grant was made in recognition of past service and vested immediately, resulting in \$43,703 of stock-based compensation expense. Under the terms of the Plan, vested options expire ninety days after the director or employee terminates the service affiliation with the Bank. In 2007, vested grants for a total of 26,500 shares to four retiring directors were modified and the expiration provisions with the termination of service were waived.

Note M – Regulatory Matters

The Bank is subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory - and possibly additional discretionary - actions by regulators that, if undertaken, could have a direct material effect on the Bank's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of the Bank's assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. The Bank's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the table below) of total and Tier 1 capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier 1 capital (as defined) to average assets (as defined).

As of December 31, 2008, the most recent notification from the Office of the Comptroller of the Currency categorized the Bank as "well capitalized" under the regulatory framework for prompt corrective action. As of December 31, 2008, the Bank's capital level and ratios indicate that it is "well capitalized" under the regulatory framework for prompt corrective action.

To be categorized as well capitalized, the Bank must maintain minimum ratios as set forth in the table below. Management believes, as of December 31, 2008, that the Bank meets all capital adequacy requirements to which it is subject. The following table also sets forth the Bank's actual capital amounts and ratios (dollar amounts in thousands):

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Note M – Regulatory Matters (Continued)

	Amount of Capital Required					
	Actual		For Capital Adequacy Purposes		To Be Well-Capitalized Under Prompt Corrective Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
As of December 31, 2008:						
Total Capital (to Risk-Weighted Assets)	\$17,902	22.9%	\$ 7,604	8.0%	\$7,810	10.0%
Tier 1 Capital (to Risk-Weighted Assets)	\$16,894	21.6%	\$ 3,124	4.0%	\$4,686	6.0%
Tier 1 Capital (to Average Assets)	\$16,894	17.8%	\$ 3,802	4.0%	\$4,752	5.0%
As of December 31, 2007:						
Total Capital (to Risk-Weighted Assets)	\$23,232	43.2%	\$ 4,304	8.0%	\$5,380	10.0%
Tier 1 Capital (to Risk-Weighted Assets)	\$22,559	41.9%	\$ 2,152	4.0%	\$3,228	6.0%
Tier 1 Capital (to Average Assets)	\$22,559	31.3%	\$ 2,880	4.0%	\$3,599	5.0%

Under federal law, a national bank generally may not pay cash dividends in excess of the bank's net profits, if it would impair the bank's capital, if the bank is in default on the payment of any assessment due to the FDIC, or if the bank has not paid all cumulative dividends on outstanding preferred stock. In addition, unless and until a bank's additional paid in capital account is equal to its common stock account, no dividend can be declared until the bank has carried to its additional paid-in capital account not less than one-tenth of its net profits for the preceding two consecutive half-years (in the case of annual dividends). The Bank cannot legally pay dividends at this time and the Bank intends to follow a policy of retaining earnings, if any, for the purpose of increasing its net worth and reserves. Accordingly, the Bank does not anticipate that cash dividends will be declared for several years and no assurance can be given that its earnings will permit the payment of dividends of any kind.

Note N – Fair Value Measurement

The following is a description of valuation methodologies used for assets and liabilities recorded at fair value:

Securities: The fair values of securities available for sale are determined by obtaining quoted prices on nationally recognized securities exchanges (Level 1) or matrix pricing, which is a mathematical technique used widely in the industry to value debt securities without relying exclusively on quoted prices for specific securities but rather by relying on the securities' relationship to other benchmark quoted securities (Level 2).

Loan Servicing Rights: Loan servicing rights are initially recorded at fair value in accordance with SFAS No. 156, *Accounting for Servicing of Financial Assets, an amendment of SFAS No. 140* and are subsequently measured using the amortization method which requires servicing rights to be amortized into non-interest income in proportion to, and over the period of, the estimated future net servicing income of the underlying loans. Loan servicing rights are evaluated for impairment subsequent to initial recording. Impairment is determined by stratifying rights into groupings based on predominant risk characteristics, such as interest rate, loan type and investor type. Impairment is recognized through a valuation allowance for an individual grouping, to the extent that fair value is less than the carrying amount. Loan servicing rights do not trade in an active market with readily observable prices. Accordingly, the Bank determines the fair value of loan servicing rights by estimating the present value of the future cash flows associated with the loans being serviced. Key economic assumptions used in measuring the fair value of loan servicing rights include prepayment speeds and discount rates. While market-based data is used

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Note N – Fair Value Measurement (Continued)

to determine the input assumptions, the Bank incorporates its own estimates of assumptions market participants would use in determining the fair value of loan servicing rights (Level 3).

Collateral-Dependent Impaired Loans: The Bank does not record loans at fair value on a recurring basis. However, from time to time, fair value adjustments are recorded on these loans to reflect (1) partial write-downs, through charge-offs or specific reserve allowances, that are based on the current appraised or market-quoted value of the underlying collateral or (2) the full charge-off of the loan carrying value. In some cases, the properties for which market quotes or appraised values have been obtained are located in areas where comparable sales data is limited, outdated, or unavailable. In these cases, fair value estimates for collateral-dependent impaired loans are obtained from real estate brokers or other third-party consultants (Level 3).

The Bank has no liabilities measured and recorded at fair value as of December 31, 2008. The Bank had no assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) during 2008.

The following table provides the hierarchy and fair value for each major category of asset measured at fair value at December 31, 2008:

	Fair Value Measurements Using			Total
	Level 1	Level 2	Level 3	
Assets measured at fair value on a recurring basis				
Assets:				
Securities Available for Sale	\$ -	\$ 12,703,713	\$ -	\$ 12,703,713
Assets measured at fair value on a non-recurring basis				
Loan Servicing Rights	\$ -	\$ -	\$ 25,673	\$ 25,673
Collateral-Dependent Impaired Loans, Net of Specific Reserves	\$ -	\$ -	\$ 965,103	\$ 965,103

Loan servicing rights, which are carried at the lower of cost or fair value, were written down to fair value of \$25,673, resulting in a valuation allowance of \$4,513. A charge of \$4,513 was included in earnings for the period.

Collateral-dependent impaired loans, which are measured for impairment using the fair value of the collateral, had a carrying value of \$1,232,505, and a specific reserve of \$267,402 at December 31, 2008.

Note O – Subsequent Event

On April 10, 2009 in connection with the Troubled Assets Relief Program (“TARP”), the Bank received \$2,211,000 from the U.S. Treasury in exchange for the issuance 2,211 shares of the Bank’s Fixed Rate Non-Cumulative Perpetual Preferred Stock, Series A and a related warrant for 110 shares of the Bank’s Fixed Rate Non-Cumulative Perpetual Preferred Stock, Series B, which represents 5% of the Series A Preferred Stock. The aggregate redemption price of both Series A and Series B Preferred Stock will be \$2,321,000. The difference between the aggregate redemption price and proceeds net of issuance costs of approximately \$35,000 or \$145,000 will be accreted against retained earnings over the estimated five-year life of the Preferred Stock reducing the reported income available for common shareholders.

The Preferred Stock, Series A will pay non-cumulative dividends at a rate of 5% per year for the first five years and 9% per year thereafter. The Preferred Stock, Series B will pay non-cumulative dividends at a rate of 9% per year. The Series A Preferred Stock may be redeemed by the Bank after three years or earlier, if the Bank raises Tier 1

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Note O – Subsequent Event (Continued)

capital in an amount not less than 25% of the aggregate redemption price of the Series A and Series B preferred. The Series B Preferred Stock may be redeemed after all of the Series A Preferred Stock has been redeemed.

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MISSION STATEMENT

The mission of First Business Bank is to provide personal and business financial services to select San Diego businesses that can benefit from a comprehensive, consultative relationship. As their Trusted Advisor, we want them to experience a unique Private Business Banking relationship.

BOARD OF DIRECTORS

John Farkash | Chairman of the Board

Thomas H. Blair, Jr. | Editor of San Diego Magazine

William V. Ehlen | President of Iron Horse Investments

Lester Machado, MD, DDS, FRCS (Ed) | Oral and Maxillofacial Surgeon

John McGrath | President of the Auerbach Trust

Nathan L. Rogge | President and CEO of First Business Bank

EXECUTIVE MANAGEMENT

Nathan L. Rogge | President and Chief Executive Officer

Paula J. Berggren | Executive Vice President and Chief Credit Officer

William T. Roche, III | Executive Vice President and Chief Financial Officer

LOCATIONS

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Phone (760) 599-7044
Fax (760) 599-7074
Manager: Sandy Apodaca

Ramona

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Ramona, CA 92065
Phone (760) 788-8788
Fax (760) 789-5576
Manager: Aracely Scott

ADDITIONAL INFORMATION

Stock Exchange Listing | The common stock is listed on Over the Counter (“OTC”) trading as FBBN.OB.

Market Maker | Western Financial Services, Richard Levinson

PROFESSIONAL CONSULTANTS

Vavrinek Trine Day & Co., LLP | Independent Accountants
Horgan, Rosen, Beckham & Coren, L.L.P. | Legal Counsel
Lambert & Rogers | Legal Counsel