MidWest*One* Financial Group, Inc.

White Paper

Loan Pool Participations

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MidWest*One* and Loan Pools

Background

In the March, 2008 merger of publicly held Midwest*One* Financial Group, Inc., and privately owned ISB Financial Corp., ISB was the surviving entity. The management of ISB Financial Corp.'s lead bank, Iowa State Bank & Trust Co., became the top officers of the combined banks and switched the name of the bank to the MidWest*One* brand. In their new role, they inherited the loan pool business of the former MidWest*One* Bank.

The former MidWest*One* Bank had been participating in loan pools since 1988. In this line of business, pools of loans are acquired at a significant discount to the outstanding loan balances. The loan pool participations have historically been a high-yield activity, but with some fluctuation from period-to-period based on cash collections, discount recovery, and net collection expenses of the servicer. Net returns averaged in excess of 10% annually from April, 1988 to February, 2008.

On the date of the merger, the former MidWest*One* Bank had a net $87.3 million invested (after $2.1 million in loan loss reserves) in loan pools. For the fiscal year immediately preceding the merger, this category of loans had returned 8.57%.

That bank's, like the current bank's, financial success with loan pools was and is largely attributable to management's decisions based upon input from a third party servicer and the servicer's ability to evaluate prospective loan pools, determine an appropriate bid price and collect on the underlying assets. Bank management participates in the bid process, retaining ultimate veto power.

Investments in loan pools have become increasingly popular in recent years as financial institutions and other competitors have become more active at loan pool auctions conducted by the FDIC and other sellers. The bank's management makes no assurance that its agent will be able to bid successfully in the future. Certain existing competitors of the bank are substantially larger and have significantly greater financial resources. In addition, competitors may develop due diligence procedures comparable to the bank's agent's procedures.

What are loan pools?

The loan pool participations on the financial statements of MidWest*One* Bank are packages of performing, sub-performing and nonperforming loans purchased at varying discounts from the aggregate outstanding principal amount of the underlying loans. As of December 31, 2009, for instance, the bank's investment basis in its loan pool participations was $85.2 million, approximately 46.9% of the face amount of the underlying loans. At December 31, 2008, such cost basis was $95.1 million, while the contractual outstanding principal amount of the underlying loans as of that date was approximately $175.3 million.

The loan pool interests are purchased, held and serviced by the third-party independent servicing corporation. These pools of loans are purchased from large nonaffiliated banking organizations and from the FDIC acting as receiver of failed banks and savings associations. These loan pools are sold either directly by banks or other selling parties, or more commonly, through the use of a reputable broker.

Each loan pool's composition is dependent upon the characteristics of the assets to be included in a larger sale and organized into individual pools according to the goals and desires of the seller. Typically, the seller's primary desire is to maximize the price it receives for the offered loans. While certain sellers organize loan pool offerings according to regional or geographic attributes or based upon lines of business and cost centers specific to them, most sellers select loans with similar characteristics to be grouped into pools. This is done to attract buyers that target specific asset classes and attributes as they may be willing to pay a market premium for product offerings that best meet their criteria. An example might include a pool of mortgage loans, with average balances between $150,000 and $300,000, secured by single-family homes with payment history attributes and borrower credit scores falling within specified ranges. Other targeted pool offerings may include multi-family loans, commercial real estate loans, or consumer loans secured by automobiles, recreational vehicles or mobile homes. Some pools may contain a mixture of various types of loans, performance characteristics, and may be concentrated within a more localized market area. However, the bank presently has minimal exposure in the loan pools to consumer real estate, subprime credit or construction and real estate development loans.

As loan pools are put out for bid (generally in a sealed bid auction) the servicer's due diligence teams may go on-site to review loan documents, or more commonly, perform on-line due diligence through the review of scanned images of the source documents. The due diligence team acquires market and property information using a multitude of tools, not limited to but including:- working with local real estate brokers, interviewing local resources about market conditions, utilizing public information sources, and performing on-site collateral inspections. They make assessments of sellers' underwriting standards and completeness of all loan documentation. As part of the process, each loan is evaluated in terms of payment history, borrowers' willingness and ability to pay, credit scores for consumer loans, geography and local economic conditions, loan purpose, amount and quality of loan collateral, loan maturity and structure, and note coupon.

After the due diligence, bank management reviews the status and decides if it wishes to continue in the process. If the decision to consider a bid is made, the servicer conducts additional analysis to determine the appropriate bid price. This analysis involves discounting loan cash flows with adjustments made for expected losses, changes in collateral values as well as targeted rates of return. A cost or investment basis is assigned to each individual loan at cents per dollar (discounted price) based on the servicer's assessment of the recovery potential of each loan.

Armed with this information, if the bank agrees to bid through the servicer, a bid is entered. Once a bid is awarded to the bank's servicer, the bank assumes the risk of profit or loss but on a non-recourse basis so the risk is limited to its initial investment. The extent of the risk is also dependent upon: the debtor or guarantor's financial condition, the possibility that a debtor or guarantor may file for bankruptcy protection, the servicer's ability to locate any collateral and obtain possession, the value of such collateral, and the length of time it takes to realize the recovery either through collection procedures, legal process, or resale of the loans after a restructure.

The underlying loans in the loan pool participations include both fixed and variable-rate instruments. No amounts for interest due are reflected in the carrying value of the loan pool participations. Based on historical experience, the average period of collectibility for loans underlying the bank's loan pool participations, many of which have exceeded contractual maturity dates, is approximately three to five years.

Loan pool participations are shown on the bank's balance sheet as a separate asset category. The original carrying value or investment basis of loan pool participations is the discounted price paid by the company to acquire its interests, which, as noted, is less than the face amount of the underlying loans. MidWestOne's investment basis is reduced as the servicer recovers principal on the loans and remits its share to the bank or as loan balances are written off as uncollectible.

Loan pool interest and discount income

Loan pools generate income for the "interest and discount income" category on the income statement in two ways. First, interest collected by the servicer is posted as interest income. In general, the servicer does not accrue interest for the loan pools, but only recognizes it as received on a cash basis. The second way income for this category is generated for the income statement is through the pay-off of an outstanding loan or any principal payments on the loan in excess of the purchase cost. For example, the bank owns a loan with a balance of $100,000, which it purchased for $50,000. If this loan were to pay off in full then half would be applied to reduce the principal amount of the loan on the balance sheet and $50,000 would be recognized as interest and discount income on the income statement. See the addendum for a more detailed example.

Interest and discount income is net of collection expenses of the servicer, net of the servicing fee and share of recovery profit paid to the servicer and net of all impairment charges or losses on the sale of Other Real Estate. That portion of interest and discount income that is actually interest is only recognized when remitted by the servicer for those loans having nonaccrual status in accordance with SOP 03-3. Interest income collected is reflected in the bank's income statement as interest income and discount on loan pool participations.

When reporting to the SEC, loan restructures, write-downs, or write-offs within the loan pools are not included in the bank's separate disclosures for its internally originated loan portfolio but when reporting to the federal and state regulators, loan pool restructures, write-downs or write-offs are combined with the bank's parallel information.

MidWest*One*'s portfolio holds approximately 95% of participation interests in pools of loans owned and serviced by States Resources Corporation, the third-party loan servicing organization in Omaha, Nebraska. SRC's owner holds the rest. The bank does not have any ownership interest in or control over States Resources.

Collection expenses include salary and benefits paid by the servicer to its employees, legal fees, costs to maintain and insure other real estate owned, and other operating expenses. Under the terms of the bank's agreement with the servicer, the latter receives a servicing fee based on a percentage of the gross monthly collections of principal and interest, net of collection costs. Additionally, the servicer receives a tiered percentage share of the recovery profit in excess of the bank's required return on investment on each individual loan pool. The servicer's percentage share of recovery profit is linked to a tiered index depending upon the return on investment achieved on the profits which exceed the investor's minimum return on investment. The bank's minimum required return on investment is based on the two-year treasury rate at the time a loan pool is purchased plus a percentage. For every one percent increase obtained over the investor's minimum required return, the servicer's percentage moves up one tier. The investor retains 100% of all profits up to the minimum required return on investment attributable to each loan pool.

In the event the return on a particular pool does not exceed the required return on investment, the servicer does not receive a percentage share of the recovery profit. The servicer provides the bank with monthly reports detailing collections of principal and interest, face value of loans collected and those written off, actual operating expenses, remaining asset balances (both in terms of cost basis and principal amount of loans), a comparison of actual collections and expenses with targeted collections and budgeted expenses, and summaries of remaining collection targets.

The servicer also provides aging reports and ''watch lists'' for the loan pools. On a quarterly basis, those loans that are determined to have a possible recovery of less than the assigned basis amount are placed on a ''watch list.'' The amount of basis exceeding the estimated recovery amount on the ''watch list'' loans is written off by a charge against discount income. Monthly meetings are held between the bank and the servicer to review collection efforts and results, to discuss future plans of action and to discuss potential opportunities. Additionally, personnel from both organizations communicate on almost a daily basis to discuss issues regarding the loan pools. Bank representatives visit the servicer's operation on a regular basis; and the bank's loan review personnel perform loan quality reviews on a regular basis. The servicer has a SAS 70 audit performed annually by an independent auditor.

The bank, when reporting to its Board or the SEC, does not include any amounts related to the loan pool collectibility of the underlying loans or any amounts related to the loan pool participations in its totals of nonperforming loans. Additionally, the servicer, as part of the ongoing collection process may, from time-to-time, foreclose on real estate mortgages and acquire title to property to satisfy such debts. This real estate may be held by the servicer as ''other real estate owned'' until it can be sold. Because the bank's investments in loan pools are classified separately from its loan portfolio, the bank, when reporting to its Board or the SEC, does not include the other real estate owned that is held by the servicer with the amount of any other real estate that the bank may hold directly as a result of its own foreclosure activities.

Bank management has reviewed the recoverability of the underlying loans and believes that the carrying value does not exceed the fair value of its investment in the loan pools.

Fiscal 2009 results

The bank acquired new loan pool participations totaling $28.3 million during the period from the merger to December 31, 2008 and $14.1 million in fiscal 2009. At the year end just past, the bank's investment basis in loan pool participations was about 46.1% of the face amount of the underlying loans.

Most recent loan pool performance

Most of the decrease in interest and discount income related to the loan participations for the quarter ended December 31, 2009 was due to a reduction in the number of loan pay-offs and therefore a reduction in the amount of discount income generated. The net yield was lower for the year than for 2008 primarily due to elevated charge-offs - deducted from discount income - in the pooled loan portfolio, losses on the sale of other real estate owned, and slowed collections as borrowers saw their ability to refinance decline due to the continued tightness in the credit markets. Interest and discount income on loan pool participations was $102,000 (net of all fees, expenses and charges) for the fourth quarter compared with $1.3 million for the fourth quarter of 2008. For 2009, interest and discount income totaled $1.8 million compared with $4.5 million the year before.

The net "all-in" yield on loan pool participations was 1.73% in the fourth quarter of 2009 and 3.21% for the full year, down from 6.55% for the 2008 fourth quarter and 8.41% for that full calendar year.

Key factors in reduced loan pool portfolio performance include:

1) Diminished availability of credit to customers, reducing their ability to refinance and SRC's ability to increase yields by bringing discount income forward faster.
2) Declining market value and liquidity of collateral especially related to an increased inventory of other real estate owned and longer carrying periods and higher associated costs to hold and maintain properties.
3) Increased payment defaults in the portfolio.
4) Slower legal process due to increased collection and foreclosure activity in several markets.
5) Decreases in base interest rates on floating rate obligations.

The above factors have also created opportunity in the current environment because deeper purchase discounts have provided the possibility for attractive coupon yields. The present environment provides attractive yields from regular payments with less reliance upon a strong refinance market.

The income and yield on loan pool participations may vary in future periods due to the volume and accretable yield on loan pools purchased.

Cash inflows for loan pool participations were $14.1 million during 2009 compared to a $28.3 million inflow during 2008. The loan pool investment balance shown as an asset on the bank's balance sheet represented the discounted purchase cost of the loan pool participations. The bank acquired no new loan pool participations during the fourth quarter 2009.

As of September 30, 2009, the categories of loans by collateral type in the loan pools were commercial real estate - 55%, commercial loans - 8%, agricultural and agricultural real estate – 11%, single-family residential real estate - 12% and other loans - 14%.

At September 30, 2009, loans in the southeast United States totaled about 39%. The northeast was next at 33%, central 19%, southwest 8% and northwest 1%. The highest concentration of assets is in Florida at about 18%, with the next highest Ohio at 12% and then Colorado and Pennsylvania both at about 7%.

At the end of the third quarter, approximately 54% of the loans were contractually current or less than 90 days past due, 46% were contractually past due 90 days or more. Many of the loans contractually past due when purchased were more deeply discounted at the time. The 46% contractually past due includes loans in litigation and foreclosed property. As of September 30, 2009, loans in litigation totaled approximately $16.0 million, while foreclosed property was approximately $9.3 million.

Current Plans

The bank's management anticipates its continuing involvement in loan pool participations for the foreseeable future. Management has set a target range for loan pool participations of between $90 million and $110 million and continues to be active in bidding on new pools. The most recently purchased pools have performed well and management believes the business will perform acceptably over the long term.

Accounting treatment of loan pools

The loan pool investment balance shown as an asset on the company's statement of condition represents the discounted purchase cost of the loan pool participations. This loan pool accounting relates to management's estimate that the investment amount reflected does not exceed the estimated net realizable value, or the fair value, of the underlying collateral securing the purchased loans. In evaluating the purchased loan portfolio, management takes into consideration many factors, including the borrowers' current financial situation, the underlying collateral, current economic conditions, historical collection experience, and other factors relative to the collection process. If the estimated realizable value of the loan pool participations is overstated, the company's yield on the loan pools would be reduced.

The loan pools acquired are accounted for in accordance with the provisions of Statement of Position 03-3 issued by the Accounting Standards Executive Committee of the American Institute of Certified Public Accountants. SOP 03-3 provides updated guidance on the accounting for purchased loans that show evidence of deterioration of credit quality since origination and for which it is probable, at acquisition, that the purchaser will be unable to collect all contractually required payments receivable. SOP 03-3 generally requires that the excess of the estimated cash flows expected to be collected on the loan over the initial investment be accreted over the estimated remaining life of loan. According to SOP 03-3, in order to apply the interest method of recognition to these types of loans, there must be sufficient information to reasonably estimate the amount and timing of the cash flows expected to be collected.

When that is not the case, the loan should be accounted for as a nonaccrual status applying the cash basis income recognition to the loan. The bank has developed and implemented procedures to determine if accretion of the discount (accretable yield) on the purchased loans in a pool is required under SOP 03-3. Given the impaired nature of the loan pools typically purchased, the individual loans are evaluated for SOP 03-3 purposes by the end of a six-month window from the date of purchase. This provides time for the servicer to assess the quality of the loans and assign a basis to each loan within the pool.

Purchased loans are evaluated utilizing various criteria including: past-due status, late payments, legal status (not in foreclosure, judgment against the borrower, or referred to legal counsel), frequency of payments, collateral adequacy and the borrower's financial condition. If all the criteria are met, the individual loan will utilize the accounting treatment required by SOP 03-3 with the accretable yield difference between the expected cash flows and the purchased basis accreted into income on the level yield basis over the anticipated life of the loan. If any of the six criteria are not met, the loan is accounted for on the cash-basis of accounting. In the event a prepayment is received on a loan accounted for under SOP 03-3, the accretable yield is recomputed and the revised amount accreted over the estimated remaining life of the loan on the level yield basis. If a loan subject to accretable yield fails to make timely payments, it is subject to classification and an allowance for loss would be established.

Cautionary Note Regarding Forward-Looking Statements

Statements made in this paper, other than those concerning historical financial information, may be considered forward-looking statements, which speak only as of the date of this document and are based on current expectations and involve a number of assumptions. These include, among other things, statements regarding future results or expectations. The Company intends such forward-looking statements to be covered by the safe harbor provisions for forward-looking statements contained in the Private Securities Litigation Reform Act of 1995 and is including this statement for purposes of these safe harbor provisions. The Company's ability to predict results, or the actual effect of future plans or strategies, is inherently uncertain. Factors that could cause actual results to differ from those set forth in the forward-looking statements or that could have a material effect on the operations and future prospects of the Company include, but are not limited to: (1) the strength and the local and national economy; (2) changes in interest rates, legislative/regulatory changes, monetary and fiscal policies of the U.S. government, including policies of the U.S. Treasury and the Federal Reserve Board; (3) the loss of key executives or employees; (4) changes in the quality and composition of the Company's loan and securities portfolios; demand for loan products; deposit flows; competition; demand for financial services in the Company's respective market areas; implementation of new technologies; ability to develop and maintain secure and reliable electronic systems; and accounting principles, policies, and guidelines; (5) expected revenue synergies and cost savings from the merger may not be fully realized or realized within the expected time frame; and (6) other risk factors detailed from time to time in filings made by the Company with the SEC.

Addendum

A quick primer on Discount Income (and effects of payoffs/refinancing on yields):

Discount Income is the income earned on recovered principal, which is essentially a capital gain recognized on each principal payment received or at the time of final settlement or payoff. Assume a loan with principal balance of $100,000 is purchased for $90,000, or 90% of par value. The loan has a fixed interest rate of 9.00% with contractual principal and interest installment payments of $2,500 per month, amortizing in full in approximately 48 months, providing a projected yield to maturity of 14.67%.

The first monthly payment of $2,500 would include interest of $750 and principal recovery of $1,750. This payment would provide $750 of interest income, $175 of discount income (10% of principal), and $1,575 of basis recovery (90% of principal).

Assuming, the loan is refinanced and paid off at the end of year 1, the yield on the asset would increase from the projected 14.67% yield-to-maturity to a 21.37% yield. Interest income received during the first year would be $8,111.72 and principal receipts would be $21,888.28 ($2,188.82 towards discount income and $19,699.45 of basis recovery). At payoff, the remaining $78,111.72 principal collected would provide an additional $7,811.72 of discount income (10% of principal balance). For refinanced/paid off accounts, a more substantial increase in yield occurs along with the following factors: deeper purchase discounts, lower contractual interest rates, longer amortization periods, the smaller the proportion of contractual payment attributable to principal repayments (i.e. interest only loans), and earlier payoff dates. The above example demonstrates why refinancing activity has been so important to historical portfolio yields, however, this is a very extreme example of the potential yield premium because it uses a high representative purchase price - 90% of par value.

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For your notes