

To Our Shareholders

From: Robert W. Zapp

As all who read this report are aware, 2008 will be remembered as one of the most economically challenging years in history. Our nation has witnessed a record number of foreclosures, higher levels of unemployment, and record low interest rates as the Federal Reserve fought to stimulate the economy. Unprecedented challenges faced the housing, automotive and financial services industries as well as many other segments of the economy. As I present the 2008 Annual Report to you, our shareholder, it is important that I recognize and express my appreciation to our employees and directors for the hard work they put forth during these challenging times.

It is against this backdrop that I present

the Bank's financial performance for 2008, one with which I believe you will be most pleased. In 2008, we increased Net Income by 2% and Earnings Per Share by 5%. We increased our Dividends by 17%, while most institutions slashed or even eliminated dividends altogether. We continued to take a conservative approach to addressing loan losses and delinquencies, as demonstrated by a near 1 to 1 ratio of non-performing loans to our allowance for loan losses at year end. Our business model has allowed us to grow and prosper despite the tough economy of the past 18 months. While I remain cautious about the economy as a whole, I am confident in our ability to strengthen and expand this franchise. I foresee opportunities to continue our growth both organically and through acquisition. And, with the dedication of our employees and leadership from our directors, the years ahead are promising for The Bank of Kentucky.

Putting Things in Perspective

Many businesses and individuals continue to struggle through an economic downturn that has touched every segment of our economy. Triggered by the severe disruption in the real estate market during the second half of 2007, we witnessed historic failures and seismic shifts throughout 2008, the impacts of which were felt globally. Credit markets slowed, liquidity became scarce and businesses retrenched, furthering the downward spiral. Every community experienced the effects. The Labor Department released figures showing unemployment hit a 16-year high of 7.2% in December as 2.6 million jobs disappeared in 2008, the most since 1945. Major stock indices declined throughout the year leading to large reductions in the

market value of equities. The S&P Index, for example, declined more than 38% in 2008. Entering 2009, the outlook is equally bleak, as most indicators signal the current recession will continue into its second year.

Within our industry, the financial crisis of 2008 changed the banking landscape forever. Banks that engaged in subprime mortgages, invested in the securities that traded them, or participated in other risky derivatives tied to these markets, struggled to survive. Almost weekly, banks grabbed headlines as many large institutions grappled with soaring loan losses, increased delinquencies, and mark-to-market accounting that challenged liquidity and capital levels. As the year progressed, several banks failed, including the largest bank failure in history.

By Fall 2008, the crisis reached a critical level as Fannie Mae and Freddie Mac were placed in conservatorship, a major investment firm filed for bankruptcy, a large insurer teetered on insolvency, major banks announced acquisitions, and the Dow experienced its largest one-day point-drop in history. It was with this backdrop that Congress passed the **Emergency Economic Stabilization Act of 2008** in October 2008.

In summary, the act authorized the U.S. Treasury Department to stabilize financial institutions by injecting capital and buying troubled assets in an attempt to reestablish confidence in the U.S. credit markets. In addition, the FDIC provided a temporary increase in FDIC Deposit Insurance to \$250,000 per depositor and unlimited coverage for non-interest bearing transaction accounts until December 2009. Although it may take some time to determine what effects these actions will have on the economy as a whole, it is certain that our industry has changed dramatically. I put these events into perspective because for our Bank, the turbulence in 2008 translates into significant opportunities for our Company to grow and emerge as a leader.

How our strategy kept us on track

Despite these events and the negativity surrounding our industry, we have maintained sound strategies that helped The Bank of Kentucky avoid the crippling effects of the current recession. For example, The Bank of Kentucky never engaged in subprime or other aggressive loan programs. In fact, our residential mortgage outstandings grew by 13% in 2008 as customers found value in a community bank and our fair lending practices. The Bank also maintained conservative investment strategies, which



*Robert W. Zapp,
President and
Chief Executive Officer*

shielded the Bank from declining asset values associated with ownership in Fannie Mae and Freddie Mac common and preferred stock. In addition, The Bank of Kentucky never held derivative securities associated with credit default swaps or collateralized debt obligations. The Bank continues to maintain sound credit practices and responsible lending, focusing on personal and business loans within our region. Total loans grew throughout the year, exceeding \$1 billion, up 8% from 2007. Relative to our competition, the Bank's Net Interest Margin held steady due to a continued focus on reducing interest rate risk on both sides of the balance sheet. With little long-term exposure, we are confident the Bank is positioned to meet the challenges of a historically low interest rate environment.

Overall, these practices and decisions benefited each and every shareholder. The Bank's capital position at the end of the year was the highest it's been in many years. Total Risk-Based Capital was over 11% at the end of 2008, well above regulatory levels. Net Income grew to a record \$11.3 million for the year, both total loans and total deposits exceeded \$1 billion for the first time in the Bank's history, Dividends increased significantly, and most notably, Earnings Per Share increased from the previous year, up by 5%.

A few highlights are as follows:

Net Income	grew to a record \$11.3 million, up 2%
Diluted Earnings per Share	rose 5% to \$2.02 / share
Total Assets	are \$1.26 billion, up 2%
Total Deposits	grew to \$1.07 billion, up 1%
Total Loans	increased 8%, over \$1 billion
Dividends	rose 17% to \$.54 /share

Yes, these accomplishments are noteworthy, but The Bank of Kentucky was not immune to the credit crisis. The Bank experienced record net charge-offs in 2008, totaling \$3.4 million. We ended the year with non-performing loans of \$10.1 million and increased the provision for loan losses by \$3.3 million in 2008. We continue to closely monitor our entire loan portfolio, identifying areas of concern and preparing for challenges ahead. We feel confident in our ability to manage and mitigate loan deterioration going forward in light of an unpredictable economy. It is important to note that relative to our peer group and the banking industry as a whole, our level of losses and delinquencies remain low. So, as we grow loan assets in 2009, monitor the economic climate closely, and mitigate losses in the existing portfolio, we maintain a commitment to the high levels of credit quality and proven lending standards that has served us well for many years.

Major Events in 2008

Emergency Economic Stabilization Act of 2008

On October 3, 2008, the Emergency Economic Stabilization Act was signed into law in response to the expanding financial crisis. A major piece of this legislation authorized the Treasury Department designed to implement the **Troubled Asset Relief Program** (TARP), which was designed to “attract broad participation by healthy

institutions, to stabilize the financial system and increase lending for the benefit of the U.S. economy and the American people.”¹ By purchasing qualifying capital in U.S. banking organizations through the Capital Purchase CPP, the U.S. Department of the Treasury had a tool to pump fresh capital into the banks in order to meet its goal. As a healthy institution that is considered “well-capitalized” by the FDIC, The Bank of Kentucky applied for, and was subsequently approved to participate in the CPP. By meeting all the eligibility requirements as set forth by the Treasury Department, The Bank of Kentucky Financial Corporation was approved for the maximum amount of capital for purchase by the Treasury, which is an amount equal to 3% of the Total Risk-Weighted Assets at the Bank. On February 13, 2009, The Bank of Kentucky Financial Corporation completed the sale of \$34 million of preferred shares to the Treasury at an annual dividend expense of 5% and issued Treasury warrants for common shares as required under the CPP. Even though we maintain a strong balance sheet and have adequate liquidity, the capital injection from the Treasury strengthens the Bank in the face of an uncertain and potentially prolonged economic downturn. It will allow us to increase, where possible and prudent, additional consumer and commercial lending to stimulate economic activity in our market. In addition, the investment will facilitate appropriate acquisitions of bank

branches, or entire banks, whose capacity to flourish or even survive in the current economy has become suspect.

As a shareholder, rest assure that The Bank of Kentucky has already studied the impact of receiving TARP funds and is focused on leveraging the investment as a means to fuel sustainable financial performance over the long term.

The Bank of Kentucky Listed on the NASDAQ

As shareholders of The Bank of Kentucky, we were very proud to announce to you in November 2008 the listing of our company stock on the NASDAQ Global Market. Recognized around the globe as the largest and most renowned U.S. market, NASDAQ provides your stock significant penetration and exposure to all segments of the business community. The benefits of becoming a NASDAQ member are numerous. NASDAQ is the largest U.S. electronic stock exchange and has the highest listing standards, requiring its members to meet stringent corporate governance standards. With over 3,200 companies, NASDAQ trades more shares per day than any other U.S. market, a venue that offers its members full exposure to all types of investors. In addition, we receive a robust suite of tools, technology, and assistance that improves our ability to understand the market, communicate with shareholders, identify opportunities, and operate more efficiently.

I believe the decision and subsequent approval to be listed on NASDAQ shows our stockholders the ongoing commitment I share with our Board of Directors to add value and confidence in the future growth of the company. Our listing on NASDAQ is an important milestone in the development and future growth of the Company. We believe this move will improve the visibility of our



stock and provide us with greater exposure to investors. It's more than just a membership in a leading stock market, it is another example of the promise and potential The Bank of Kentucky possesses going forward.

Looking Ahead

The Bank of Kentucky has been in business since 1990, growing lasting relationships and building a solid base of clients. We have money to lend, products and services to meet any financial need, and employees with the knowledge and expertise to be the "Banker" everyone deserves. I am confident that our strategy will continue to serve you, the shareholder, well into the future as the Bank looks for new ways to improve how we do business, service our customers, and address the many needs of the community. Despite these uncertain times, you can expect sound financial management practices from me and my leadership team. Regardless of the challenges that land at our doorstep, we have the tools and capabilities to continue the course we chartered in 1990.

A handwritten signature in black ink that reads "Robert W. Zapp". The signature is written in a cursive, flowing style.

Robert W. Zapp

PRESIDENT AND CEO

THE BANK OF KENTUCKY FINANCIAL CORPORATION