FIRST MIDWEST BANCORP INC
Form 10-K
March 01, 2011
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

(Mark One)

[X] Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the fiscal year-ended **December 31, 2010**

or

[ ] Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the transition period from __________ to __________

Commission File Number 0-10967

FIRST MIDWEST BANCORP, INC.

(Exact name of registrant as specified in its charter)

Delaware	**36-3161078**
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification No.)

One Pierce Place, Suite 1500

Itasca, Illinois 60143-9768

(Address of principal executive offices) (zip code)

Registrant s telephone number, including area code: **(630) 875-7450**

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Name of each exchange on which registered
Common Stock, $.01 Par Value	The Nasdaq Stock Market
Preferred Share Purchase Rights	The Nasdaq Stock Market

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes [X] No [ ].

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes [ ] No [X].

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes [X] No [ ].

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. [ ].

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes [X] No [ ].

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Large accelerated filer [X] Accelerated filer [ ] Non-accelerated filer [ ].

Indicate by check mark whether the registrant is a shell Company (as defined in Rule 12b-2 of the Exchange Act). Yes [ ] No [X].

The aggregate market value of the registrant s outstanding voting common stock held by non-affiliates on June 30, 2010, determined using a per share closing price on that date of $12.16, as quoted on The Nasdaq Stock Market, was $834,080,362.

As of March 1, 2011, there were 74,543,280 shares of common stock, $.01 par value, outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of Registrant s Proxy Statement for the 2011 Annual Stockholders Meeting - Part III

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GLOSSARY OF TERMS

First Midwest Bancorp, Inc. provides the following list of acronyms as a tool for the reader. The acronyms identified below are used in Management s Discussion and Analysis of Financial Condition & Results of Operations and in the Notes to Consolidated Financial Statements.

2011 Proxy Statement:	the Company s definitive Proxy Statement for our 2011 Annual Meeting of Stockholders to be held on May 18, 2011
Act:	Bank Holding Company Act of 1956, as amended
ALCO:	Asset Liability Committee
AMT:	alternative minimum tax under the Internal Revenue Code of 1986, as amended
ARRA:	American Recovery and Reinvestment Act of 2009
ATM:	automated teller machine
Bank:	First Midwest Bank (one of the Company s two wholly owned subsidiaries)
BIA:	Banking on Illinois Act
Board:	the Board of Directors of First Midwest Bancorp, Inc.
BOLI:	bank owned life insurance
BSA:	Bank Secrecy Act
CAMELS rating:	a bank s capital level and supervisory rating
Catalyst:	Catalyst Asset Holdings, LLC (one of the Company s two wholly owned subsidiaries)
CDOs:	collateralized debt obligations
CFPB:	Consumer Financial Protection Bureau
CMOs:	collateralized mortgage obligations
Code:	the Code of Ethics and Standards of Conduct of First Midwest Bancorp, Inc.
Common Stock:	shares of common stock of First Midwest Bancorp, Inc. $0.01 par value per share, which is traded on the Nasdaq Stock Market under the symbol FMBI
Company:	First Midwest Bancorp, Inc.
Council:	Financial Stability Oversight Council created by the Dodd-Frank Act
CPP:	Capital Purchase Program enacted under TARP and the EESA
CRA:	Community Reinvestment Act of 1977
CSV:	cash surrender value
DIF:	the FDIC s Deposit Insurance Fund
Directors Plan:	Nonemployees Directors Stock Plan
EESA:	Emergency Economic Stabilization Act of 2008
Dodd-Frank Act:	the recently enacted Dodd-Frank Wall Street Reform and Consumer Protection Act
EPS:	earnings per share
Fannie Mae:	Federal National Mortgage Association
FASB:	Financial Accounting Standards Board
FDIA:	Federal Deposit Insurance Act
FDIC:	Federal Deposit Insurance Corporation
FDIC Agreements:	Purchase and Assumption Agreements and Loss Share Agreements between the Bank and the FDIC
Federal Reserve:	Board of Governors of the Federal Reserve system
FHC:	a financial holding company
FHLB:	Federal Home Loan Bank
FICO:	credit score created by Fair Isaac Corporation
FinCEN:	Financial Crimes Enforcement Network
First Midwest:	First Midwest Bancorp, Inc.
FMCT I:	First Midwest Capital Trust I
Freddie Mac:	Federal Home Loan Mortgage Corporation

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FSP:	U.S. Department of the Treasury s Financial Stability Plan
GAAP:	U.S. generally accepted accounting principles
GLB Act:	Gramm-Leach-Bliley Act of 1999
HAMP:	U.S. Department of the Treasury Home Affordable Modification Program
IBA:	Illinois Banking Act
IDFPR:	Illinois Department of Financial and Professional Regulation
LIBOR:	London Interbank Offered Rate
NOL:	net operating loss
OREO:	Other real estate owned, or properties acquired through foreclosure in partial or total satisfaction of certain loans as a result of borrower defaults
OTTI:	other-than-temporary impairment
Parent Company:	First Midwest Bancorp, Inc. on an unconsolidated basis
PSLRA:	Safe Harbor Provisions of the Private Securities Litigation Reform Act of 1995
Restoration:	Restoration Asset Management, LLC (a wholly owned subsidiary of Catalyst)
Riegle-Neal:	Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994
S&P 500:	Standard & Poor s 500 Stock Index
S&P SmallCap 600 Banks:	Standard & Poor s SmallCap 600 Banks Index
Sarbanes-Oxley:	Sarbanes-Oxley Act of 2002
SEC:	U.S. Securities and Exchange Commission
TARP:	Troubled Asset Relief Program
TLGP:	Temporary Liquidity Guarantee Program
Treasury:	U.S. Department of the Treasury
VIE:	variable interest entity

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INTRODUCTION

First Midwest Bancorp, Inc. (the Company) is a bank holding company headquartered in the Chicago suburb of Itasca, Illinois with operations throughout the greater Chicago metropolitan area as well as central and western Illinois. Our principal subsidiary is First Midwest Bank, which provides a broad range of commercial and retail banking services to consumer, commercial and industrial, and public or governmental customers. We are committed to meeting the financial needs of the people and businesses in the communities where we live and work by providing customized banking solutions, quality products, and innovative services that fulfill those financial needs.

AVAILABLE INFORMATION

We file annual, quarterly, and current reports; proxy statements; and other information with the U.S. Securities and Exchange Commission (SEC), and we make this information available free of charge on or through the investor relations section of our web site at *www.firstmidwest.com/aboutinvestor_overview.asp*. You may read and copy materials we file with the SEC from its Public Reference Room at 100 F. Street, NE, Washington DC 20549. You may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. In addition, the SEC maintains an Internet site at *http://www.sec.gov* that contains reports, proxy and information statements, and other information regarding issuers that file electronically with the SEC. The following documents are also posted on our web site or are available in print upon the request of any stockholder to our Corporate Secretary:

- Certificate of Incorporation,
- Company By-laws,
- Charters for our Audit, Compensation, and Nominating and Corporate Governance Committees,
- Related Person Transaction Policies and Procedures,
- Corporate Governance Guidelines,
- Code of Ethics and Standards of Conduct (the Code), which governs our directors, officers, and employees,
- Code of Ethics for Senior Financial Officers, and
- Luxury Policy.

Within the time period required by the SEC and the Nasdaq Stock Market, we will post on our web site any amendment to the Code and any waiver applicable to any executive officer, director, or senior financial officer (as defined in the Code). In addition, our web site includes information concerning purchases and sales of our securities by our executive officers and directors. The Company s accounting and reporting policies conform to U.S. generally accepted accounting principles (GAAP) and general practice within the banking industry. We post on our website any disclosure relating to certain non-GAAP financial measures (as defined in the SEC s Regulation G) that we may make public orally, telephonically, by webcast, by broadcast, or by similar means from time to time.

Our Corporate Secretary can be contacted by writing to First Midwest Bancorp, Inc., One Pierce Place, Itasca, Illinois 60143, Attn: Corporate Secretary. The Company s Investor Relations Department can be contacted by telephone at (630) 875-7533 or by e-mail at *investor.relations@firstmidwest.com*.

CAUTIONARY STATEMENT PURSUANT TO THE PRIVATE SECURITIES

LITIGATION REFORM ACT OF 1995

We include or incorporate by reference in this Annual Report on Form 10-K, and from time to time our management may make, statements that may constitute forward-looking statements within the meaning of the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. These statements are not historical facts, but instead represent only management s beliefs regarding future events, many of which, by their nature, are inherently uncertain and outside our control. Although we believe the expectations reflected in any forward-looking statements are reasonable, it is possible that our actual results and financial condition may differ, possibly materially, from the anticipated results and financial condition indicated in such statements. In

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some cases, you can identify these statements by forward-looking words such as may, might, will, should, expect, plan, anticipate estimate, predict, probable, potential, or continue, and the negative of these terms and other comparable terminology. We caution you n place undue reliance on forward-looking statements, which speak only as of the date of this report, or when made.

Forward-looking statements are subject to known and unknown risks, uncertainties, and assumptions and may contain projections relating to our future financial performance including our growth strategies and anticipated trends in our business. For a detailed discussion of these and other risks and uncertainties that could cause actual results and events to differ materially from such forward-looking statements, you should refer to Item 1A of Part I and Item 7 of Part II of this Annual Report on Form 10-K, including the sections entitled Risk Factors and Management s Discussion and Analysis of Financial Condition and Results of Operations, as well as our subsequent periodic and current reports filed with the SEC. However, these risks and uncertainties are not exhaustive. Other sections of this report describe additional factors that could adversely impact our business and financial performance.

Since mid-2007 the financial services industry and the securities markets in general have been materially and adversely affected by significant declines in the values of nearly all asset classes and by a serious lack of liquidity. While liquidity has improved and market volatility has generally lessened, the overall loss of investor confidence has brought a new level of risk to financial institutions in addition to the risks normally associated with competition and free market economies. The Company has attempted to list those risks elsewhere in this report and consider them as it makes disclosures regarding forward-looking statements. Nevertheless, given the uncertain economic times, new risks and uncertainties may emerge quickly and unpredictably, and it is not possible to predict all risks and uncertainties. We cannot assess the impact of all factors on our business or the extent to which any factor, or combination of factors, may cause actual results to differ materially from those contained in any forward-looking statements. We are under no duty to update any of these forward-looking statements after the date of this report to conform our prior statements to actual results or revised expectations, and we do not intend to do so.

PART I

ITEM 1. BUSINESS

First Midwest Bancorp, Inc.

First Midwest Bancorp, Inc. (First Midwest or the Company) is a bank holding company incorporated in Delaware in 1982 for the purpose of becoming a holding company registered under the Bank Holding Company Act of 1956, as amended (the Act). The Company is one of Illinois largest publicly traded banking companies with assets of $8.1 billion as of December 31, 2010 and is headquartered in the Chicago suburb of Itasca, Illinois.

History

The Company is the product of the consolidation of over 22 affiliated financial institutions in 1983, followed by several significant acquisitions, including the purchase of SparBank, Incorporated, a $449 million institution in 1997; Heritage Financial Services, Inc., a $1.4 billion institution in 1998; CoVest Bancshares, a $646 million institution in 2003; and Bank Calumet, Inc., a $1.4 billion institution in 2006.

The Company has completed three Federal Deposit Insurance Corporation (FDIC)-assisted transactions since October, 2009, as follows:

Institution Acquired	Date Acquired	Assets of Former Institution
First DuPage Bank (First DuPage)	October 23, 2009	$ 260 million
Peotone Bank and Trust Company (Peotone)	April 23, 2010	$ 130 million
Palos Bank and Trust Company (Palos)	August 13, 2010	$ 490 million

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For more information regarding these recent acquisitions, please refer to Note 5 of Notes to Financial Statements in Item 8 of this Form 10-K.

In the normal course of business, the Company may, from time to time, explore potential opportunities to acquire banking institutions. As a matter of policy, the Company generally does not comment on any dialogue or possible acquisitions until a definitive acquisition agreement has been signed.

Subsidiaries

First Midwest is responsible for the overall conduct, direction, and performance of its subsidiaries. The Company provides various services to its subsidiaries, establishes Company-wide policies and procedures, and provides other resources as needed, including capital. As of December 31, 2010, the following were the primary subsidiaries of First Midwest:

First Midwest Bank (the Bank)

The Bank conducts the majority of the Company s operations. At December 31, 2010, the Bank had $8.0 billion in total assets, $6.6 billion in total deposits, and 100 banking offices primarily in suburban metropolitan Chicago. The Bank employed 1,820 full-time equivalent employees at December 31, 2010.

First Midwest Bank Key Figures

(Dollar amounts in thousands)	December 31, 2010
Total assets	$ 7,983,225
Total deposits	$ 6,564,112
Banking offices	100
Full-time equivalent employees	1,820

The Bank operates the following wholly owned subsidiaries:

FMB Investment Corporation, which was dissolved on December 28, 2010, was a Delaware corporation that managed investment securities, principally municipal obligations, and provided corporate management services to its wholly owned subsidiary, FMB Investment Trust, a Maryland business trust. FMB Investment Trust managed many of the real estate loans originated by the Bank. All of the assets of FMB Investment Corporation were transferred to the Bank upon its dissolution.

Calumet Investment Corporation is a Delaware corporation that manages investment securities, principally municipal obligations, and provides corporate management services to its wholly owned subsidiary, Calumet Investments Ltd., a Bermuda corporation. Calumet Investments Ltd. manages investment securities and is largely inactive.

Synergy Property Holdings, LLC, a limited liability company, which manages several of the Bank s other real estate owned (OREO) properties.

Five limited liability companies (FDB Berkshire, LLC; FDB Sheridan Terrace, LLC; FDB Curtiss Street, LLC; Hamlin Wilson, LLC; and FDB Properties LLC), each of which holds OREO properties acquired by First DuPage. FDB Sheridan Terrace, LLC; FDB Curtiss Street, LLC; and FDB Properties, LLC were dissolved in early 2011.

LIH Holdings, LLC, a limited liability company, which holds an equity interest in a Section 8 housing venture.

Bankers Title Insurance, LLC was acquired as part of the acquisition of Palos and provides title insurance services to former Palos customers.

Bank Calumet Financial Services, Inc., which was dissolved on July 20, 2010, was an Indiana corporation that was largely inactive.

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First Midwest Capital Trust I (FMCT I)

First Midwest Capital Trust I is a Delaware statutory business trust formed in 2003 for the purpose of issuing $125.0 million in trust-preferred securities and lending the proceeds to the Company in return for junior subordinated debentures of the Company. The Company guarantees, on a limited basis, payments of distributions on the trust-preferred securities and payments on redemption of the trust-preferred securities. In 2009, the Company completed an exchange offer, which resulted in the Company retiring $39.3 million of the junior subordinated debentures at a discount of 20% and redeeming the corresponding trust-preferred securities associated therewith.

FMCT I qualifies as a variable interest entity for which the Company is not the primary beneficiary. Consequently its accounts are not consolidated in the Company s financial statements. However, the currently outstanding $87.3 million in trust-preferred securities issued by FMCT I are included in the Tier 1 capital of the Company for regulatory capital purposes. For a further description of FMCT I, refer to Note 11 of Notes to Consolidated Financial Statements in Item 8 of this Form 10-K. For a discussion of the potential impact of the provisions of the recently enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) on the Company s ability to continue to include the trust-preferred securities in its Tier 1 capital, see the heading Capital Guidelines appearing later in this section.

Catalyst Asset Holdings, LLC (Catalyst)

Catalyst operates in the same offices as the Bank and manages a portion of the Company s non-performing assets. The Company established Catalyst in first quarter 2010. In March 2010, the Company purchased $168.1 million of non-performing assets from the Bank and transferred them to Catalyst in the form of a capital injection. As of December 31, 2010, Catalyst had $93.1 million in non-performing assets. Since the banking subsidiary s financial position and results of operations are consolidated with the Company, this transaction did not change the presentation of these non-performing assets in the consolidated financial statements and did not impact the consolidated Company s financial position, results of operations, or regulatory capital ratios. However, the transaction improved the Bank s asset quality, capital ratios, and liquidity.

Catalyst has one wholly owned subsidiary, Restoration Asset Management, LLC (Restoration), a limited liability company, which manages Catalyst s OREO properties. The Bank provides certain administrative and management services to Catalyst and Restoration pursuant to a services agreement. The amounts charged under this services agreement are intended to reflect the actual costs to the Bank for providing such services.

Market Area

The Bank s largest service area is the suburban metropolitan Chicago market, which includes the counties surrounding Cook County, Illinois. This area extends from the cities of Zion and Waukegan, Illinois into northwest Indiana, including the cities of Crown Point and St. John, Indiana. The Company s other service areas are in central and western Illinois, which includes the cities of Champaign, Danville, and Galesburg, and eastern Iowa, or Quad-Cities , which includes the cities of Davenport, Bettendorf, Moline, and East Moline. These service areas include a mixture of urban, suburban, and rural markets. The Bank s business of attracting deposits and making loans is primarily conducted within its service areas and may be affected by significant changes in their economies. These service areas contain a diversified mix of industry groups, including manufacturing, health care, pharmaceutical, higher education, wholesale and retail trade, service, and agricultural.

When comparing large national metropolitan areas, the Chicago metropolitan area currently ranks as follows:

Third in the nation with respect to total businesses,
Third in total population,
Twelfth in average household income, and
Twelfth in median income producing assets.

Competition

The banking and financial services industry in the Chicago metropolitan area is highly competitive, and the Company expects it to remain so in the future. Generally, the Bank competes for banking customers and deposits with other local, regional, national, and internet banks and savings and loan associations; personal loan and finance companies and credit unions; and mutual funds and investment brokers. The Company faces intense competition from local and out of state institutions within its service areas.

Competition is based on a number of factors including interest rates charged on loans and paid on deposits; the ability to attract new deposits; the scope and type of banking and financial services offered; the hours during which business can be conducted; the location of bank branches and ATMs; the availability, ease of use, and range of banking services on the internet; the availability of related services; and a variety of additional services such as investment management, fiduciary, and brokerage services.

In providing investment advisory services, the Bank also competes with retail and discount stockbrokers, investment advisors, mutual funds, insurance companies, and other financial institutions for investment management clients. Competition is generally based on the variety of products and services offered to clients and the performance of funds under management and comes from financial service providers both within and outside of the geographic areas in which the Bank maintains offices.

The Company faces intense competition in attracting and retaining qualified employees. Its ability to continue to compete effectively will depend upon its ability to attract new employees and retain and motivate existing employees.

Our Business

The Bank offers a variety of traditional financial products and services that are designed to meet the financial needs of the customers and communities it serves. For over 60 years, the Bank has been in the basic business of community banking, namely attracting deposits and making loans, as well as providing wealth management, investment, and retirement planning services. The Company does not engage in any sub-prime lending, nor does it engage in non-commercial banking activities, such as investment banking services.

Deposit and Retail Services

The Bank offers a full range of deposit services that are typically available in most commercial banks and financial institutions, including checking accounts, NOW accounts, money market accounts, savings accounts, and time deposits of various types, ranging from shorter-term to longer-term certificates of deposit. The transaction accounts and time deposits are tailored to our primary service area at competitive rates. The Company also offers certain retirement account services, including individual retirement accounts.

Lending Activities

The Bank originates commercial and industrial, agricultural, commercial real estate, and consumer loans. Substantially all of the Company s borrowers are residents of the Bank s service areas. The Company s largest category of lending is commercial real estate (including residential construction loans), followed by commercial and industrial. Generally, real estate loans are secured by the land and any improvements to, or developments on, the land. Generally, loan-to-value ratios at time of issuance are 50% for unimproved land and 65% for developed land. The Company s consumer loans consist primarily of home equity loans and lines of credit.

No individual or single group of related accounts is considered material in relation to the assets or deposits of the Bank or in relation to the overall business of the Company. However, 65.8% of our loan portfolio at December 31, 2010 consisted of real estate-related loans, including construction loans, residential mortgage loans, and commercial mortgage loans.

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For detailed information regarding the Company s loan portfolio, see the Loan Portfolio and Credit Quality section of Management s Discussion and Analysis of Financial Condition and Results of Operations in Item 7 of this Form 10-K.

Sources of Funds

The Bank s ability to maintain affordable funding sources allows the Company to meet the credit needs of its customers and the communities it serves. As of December 31, 2010, deposits were a relatively stable form of funding, and they were the primary source of the Company s funds for lending and other investment purposes. Deposits funded 79.9% of the Company s assets at the end of 2010, with a net loans-to-deposits ratio of 78.3%. Consumer and commercial deposits come from the Company s primary service areas through a broad selection of deposit products. By maintaining core deposits, the Company both controls its funding costs and builds client relationships.

In addition to deposits, the Company obtains funds from the amortization, repayment, and prepayment of loans; the sale or maturity of investment securities; advances from the Federal Home Loan Bank (FHLB), brokered repurchase agreements and certificates of deposits, and federal funds purchased; cash flows generated by operations; and proceeds from sales of the Company s common and preferred stock. For detailed information regarding the Company s funding sources, see the Funding and Liquidity Management section of Management s Discussion and Analysis of Financial Condition and Results of Operations in Item 7 of this Form 10-K.

Investment Activities

The Bank maintains a sizeable securities portfolio in order to provide the Company with financial stability, asset diversification, income, and collateral for borrowing. The Company administers this securities portfolio in accordance with an investment policy that has been approved and adopted by the Board of Directors of the Bank. The Company s Asset Liability Committee (ALCO) implements the investment policy based on the established guidelines within the written policy.

The basic objectives of the Bank s investment activities are to enhance the profitability of the Company by keeping its investable funds fully employed, provide adequate regulatory and operational liquidity, minimize and/or adjust the interest rate risk position of the Company, minimize the Company s exposure to credit risk, and provide collateral for pledging requirements. For detailed information regarding the Company s securities portfolio, see the Investment Portfolio Management section of Management s Discussion and Analysis of Financial Condition and Results of Operations in Item 7 of this Form 10-K.

Supervision and Regulation

The Bank is an Illinois state chartered bank and a member of the Board of Governors of the Federal Reserve System (Federal Reserve), which has the primary authority to examine and supervise the Bank in coordination with the Illinois Department of Financial and Professional Regulation (the IDFPR). The Company is a bank holding company and is also subject to the primary regulatory authority of the Federal Reserve. The Company and its subsidiaries are also subject to extensive secondary regulation and supervision by various state and federal governmental regulatory authorities including the FDIC, which oversees insured deposits, and the U.S. Department of the Treasury (Treasury), which enforces money laundering and currency transaction regulations. In addition to banking regulations, as a public company, the Company is under the jurisdiction of the U.S. Securities and Exchange Commission (SEC) and the disclosure and regulatory requirements of the Securities Act of 1933, as amended, and the Securities Exchange Act of 1934.

Federal and state laws and regulations generally applicable to financial institutions, such as the Company and its subsidiaries, regulate the scope of business, investments, reserves against deposits, capital levels, the nature and

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amount of collateral for loans, the establishment of branches, mergers, consolidations, dividends, and other things. This supervision and regulation is intended primarily for the protection of the FDIC s deposit insurance fund (DIF) and the depositors, rather than the stockholders, of a financial institution.

The following sections describe the significant elements of the material statutes and regulations affecting the Company and its subsidiaries, many of which are the subject of ongoing revision and legislative rulemaking as a result of the government s long-term regulatory reform of the financial markets and the implementation of the Dodd-Frank Act, which is discussed in more detail later in this report. In some cases, the proposals include a radical overhaul of the regulation of financial institutions or limitations on the products they offer.

The final regulations or regulatory policies that are applicable to the Company and its subsidiaries and eventually adopted by the U.S. government may be disruptive to the Company s business and could have a material adverse effect on its business, financial condition, and results of operations. The Company cannot accurately predict the nature or the extent of the effects that any such changes would have on its business and earnings. The following discussions are summaries of the material statutes and regulations affecting the Company and its subsidiaries as currently in effect and are qualified in their entirety by reference to such statutes and regulations.

Federal Reserve System

The Federal Reserve System serves as the nation s central bank and is responsible for monetary policy. It consists of a seven member Board of Governors in Washington, D.C. and twelve reserve banks located in major cities throughout the U.S. Through the Federal Reserve Act and the Bank Holding Company Act of 1956, as amended (described below), the Federal Reserve has regulatory and supervisory responsibilities over its member banks, bank holding companies, and Edge Act and agreement corporations. The Federal Reserve also sets margin requirements, which limit the use of credit for purchasing or carrying securities, and develops and administers regulations that implement major federal laws governing consumer credit such as the Truth in Lending Act, the Equal Credit Opportunity Act, the Home Mortgage Disclosure Act, and the Truth in Savings Act.

Bank Holding Company Act of 1956, As Amended (the Act)

Generally, the Act governs the acquisition and control of banks and non-banking companies by bank holding companies and requires bank holding companies to register with the Federal Reserve. The Act requires a bank holding company to file an annual report of its operations and such additional information as the Federal Reserve may require. A bank holding company and its subsidiaries are subject to examination by the Federal Reserve. The Act s principal areas of concern include:

The Federal Reserve s jurisdiction to regulate the terms of certain debt issues of bank holding companies, including the authority to impose reserve requirements.

The acquisition of 5% or more of the voting shares of any bank or bank holding company, which generally requires the prior approval of the Federal Reserve and is subject to applicable federal and state law, including the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (Riegle-Neal) for interstate transactions.

Prohibiting (with certain exceptions) a bank holding company from acquiring direct or indirect ownership or control of more than 5% of the voting shares of any non-banking company unless the non-banking activities are found by the Federal Reserve to be so closely related to banking as to be a proper incident thereto. Under current regulations of the Federal Reserve, a bank holding company and its non-bank subsidiaries are permitted to engage in such banking-related business ventures as consumer finance, equipment leasing, data processing, mortgage banking, financial and investment advice, securities brokerage services, and other activities.

Acquisition of control (10% of the outstanding shares of any class of voting stock) of a bank or bank holding company without prior notice to certain federal bank regulators.

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Federal Reserve Act

Any transactions between the Bank and the Company and their respective subsidiaries are regulated by the Federal Reserve Act, including Sections 23A and 23B. These regulations place restrictions on loans by a bank to an affiliate, asset purchases by a bank from an affiliate, and other transactions between a bank and its affiliates. These regulations limit credit transactions between a bank and its affiliates, prescribes terms and conditions for bank affiliate transactions deemed to be consistent with safe and sound banking practices, requires arms-length transactions between affiliates, and restricts the types of collateral security permitted in connection with a bank s extension of credit to affiliates. Section 22(h) of the Federal Reserve Act limits how much and on what terms a bank may lend to its insiders and insiders of its affiliates, including executive officers and directors.

Bank holding companies act as a source of financial and managerial strength to their subsidiary banks. Under this policy, the holding company is expected to commit resources to support its bank subsidiary even at times when the holding company may not be in a financial position to provide it. Any capital loans by a bank holding company to its subsidiary bank are subordinate in right of payment to deposits and to certain other indebtedness of such subsidiary bank. The Act provides that, in the event of a bank holding company s bankruptcy, any commitment by the bank holding company to a federal bank regulatory agency to maintain the capital of a bank subsidiary will be assumed by the bankruptcy trustee and entitled to priority of payment.

Community Reinvestment Act of 1977 (the CRA)

The CRA requires depository institutions to assist in meeting the credit needs of their market areas consistent with safe and sound banking practices. Under the CRA, each depository institution is required to help meet the credit needs of its market areas by providing credit to low-income and moderate-income individuals and communities. The applicable federal regulators regularly conduct CRA examinations to assess the performance of financial institutions and assign one of four ratings to the institution s record of meeting the credit needs of its community. During its last examination, the Bank received a rating of outstanding, the highest available.

Gramm-Leach-Bliley Act of 1999 (the GLB Act)

The GLB Act allows for banks and certain other financial institutions to enter into combinations that permit a single financial services organization to offer customers a more comprehensive array of financial products and services. Such products and services may include insurance and securities underwriting and agency activities, merchant banking, and insurance company portfolio investment activities. Activities that are complementary to financial activities are also authorized. Under the GLB, the Federal Reserve may not permit a company to form a financial holding company if any of its insured depository institution subsidiaries (i) are not well-capitalized and well managed or (ii) did not receive at least a satisfactory rating in their most recent CRA exam.

Also under the GLB Act, a financial institution may not disclose non-public personal information about a consumer to unaffiliated third parties unless the institution satisfies various disclosure requirements and the consumer has not elected to opt out of the information sharing. Under the GLB Act, a financial institution must provide its customers with a notice of its privacy policies and practices. The Federal Reserve, the FDIC, and other financial regulatory agencies have issued regulations implementing notice requirements and restrictions on a financial institution s ability to disclose non-public personal information about consumers to unaffiliated third parties.

Bank Secrecy Act and USA PATRIOT Act

The Bank Secrecy and USA Patriot Acts require financial institutions to develop programs to prevent them from being used for money laundering and terrorist activities. If such activities are detected, financial institutions are obligated to file suspicious activity reports with the Treasury s Office of Financial Crimes Enforcement Network (FinCEN). These rules require financial institutions to establish procedures for identifying and verifying the

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identity of customers seeking to open new accounts. Failure to comply with these regulations could result in sanctions and possible fines. In recent years, several banking institutions have received sanctions and some have incurred large fines for non-compliance with these laws and regulations.

Consumer Financial Protection

The Bank is subject to a number of regulations intended to protect consumers in various areas such as equal credit opportunity, fair lending, customer privacy, identity theft, and fair credit reporting. For example, deposit activities are subject to such acts as the Federal Truth in Savings Act and the Illinois Consumer Deposit Account Act. Electronic banking activities are subject to federal law, including the Electronic Funds Transfer Act, and state laws. Trust activities of the Bank are subject to the Illinois Corporate Fiduciaries Act. Loans made by the Bank are subject to applicable provisions of the Illinois Interest Act, the Federal Truth in Lending Act, and the Illinois Financial Services Development Act. Significant consumer regulations include:

- *Overdraft Regulation.* The Federal Reserve has amended its regulation regarding electronic fund transfers effective July 1, 2010. The new regulation requires consumers to opt in, or affirmatively consent, to the institution s overdraft service for ATM and one-time debit card transactions before overdraft fees may be assessed on the account. Consumers must also be provided a clear disclosure of the fees and terms associated with the institution s overdraft service.

- *Registration.* The Secure and Fair Enforcement for Mortgage Licensing Act requires the registration of residential mortgage loan originators employed by banks, savings associations, credit unions, Farm Credit System institutions, and certain subsidiaries of these financial institutions to register with the Nationwide Mortgage Licensing System and Registry, obtain a unique identifier from the registry, and maintain this registration.

Dodd-Frank Wall Street Reform and Consumer Protection Act

On July 21, 2010, President Obama signed the Dodd-Frank Act into law. The Dodd-Frank Act will result in sweeping changes in the regulation of financial institutions aimed at strengthening the operation of the financial services sector. The Dodd-Frank Act s provisions that have received the most public attention generally have been those applying to, or more likely to initially affect, larger institutions. However, it contains numerous other provisions that will affect all banks and bank holding companies that will fundamentally change the system of bank oversight. The Dodd-Frank Act includes provisions that, among other things:

- Change the assessment base for federal deposit insurance from the amount of insured deposits to consolidated assets less tangible capital, eliminate the ceiling on the size of the DIF, and increase the floor on the size of the DIF. This change generally will require an increase in the level of assessments for financial institutions with assets in excess of $10 billion.

- Make permanent the $250,000 limit for federal deposit insurance and provide unlimited federal deposit insurance until January 1, 2013 for non-interest bearing demand transaction accounts at all insured depository institutions.

- Repeal the federal prohibitions on the payment of interest on demand deposits, thereby permitting depository institutions to pay interest on business transactional and other accounts.

- Centralize responsibility for consumer financial protection by creating a new agency within the Federal Reserve called the Consumer Financial Protection Bureau, which will be responsible for implementing, examining, and enforcing compliance with federal consumer financial laws.

Apply the same leverage and risk-based capital requirements that apply to insured depository institutions to most bank holding companies. One of these requirements will preclude the Company

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from including in Tier 1 capital any trust-preferred securities or cumulative preferred stock, issued on or after May 19, 2010. The Company s currently outstanding trust-preferred securities will be grandfathered and its currently outstanding Troubled Asset Relief Program (TARP) preferred securities will continue to qualify as Tier 1 capital.

Amend the Electronic Fund Transfer Act to give the Federal Reserve the authority to establish rules regarding interchange fees charged for electronic debit transactions by payment card issuers having assets over $10 billion and to enforce a new statutory requirement that such fees be reasonable and proportional to the issuer s actual cost of a transaction.

Some of these provisions may have the consequence of increasing our expenses, decreasing our revenues, and changing the activities in which we choose to engage. The specific impact of the Dodd-Frank Act on our current activities or new financial activities will be considered in the future, and our financial performance and the markets in which we operate will depend on the manner in which the relevant agencies develop and implement the required rules and the reaction of market participants to these regulatory developments. Many aspects of the Dodd-Frank Act are subject to rulemaking and will take effect over several years, making it difficult to anticipate the overall financial impact on the Company, its customers, or the financial industry in general.

Capital Guidelines

The Federal Reserve and other federal bank regulators have established risk-based capital guidelines to provide a framework for assessing the adequacy of the capital of national and state banks, thrifts, and their holding companies (collectively, banking institutions). These guidelines apply to all banking institutions, regardless of size, and are used in the examination and supervisory process and in the analysis of applications to be acted upon by the regulatory authorities. These guidelines require banking institutions to maintain capital based upon the 1988 capital accord (Basel I