

FIRST MIDWEST BANCORP INC

Form 10-K

March 02, 2015

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

(Mark One)

Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

For the fiscal year-ended December 31, 2014

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

(State or other jurisdiction of incorporation or organization)

36-3161078

(IRS Employer Identification No.)

One Pierce Place, Suite 1500

Itasca, Illinois 60143-1254

(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 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 .

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 No .

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 No .

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§232.405 of this chapter) 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 is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

(Do not check if a smaller reporting company)

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

The aggregate market value of the registrant's outstanding voting common stock held by non-affiliates on June 30, 2014, determined using a per share closing price on that date of \$17.03, as quoted on the NASDAQ Stock Market, was \$1,226,970,577.

As of February 26, 2015, there were 77,958,815 shares of common stock, \$0.01 par value, outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Registrant's Proxy Statement for the 2015 Annual Stockholders' Meeting are incorporated by reference into Part III.

FIRST MIDWEST BANCORP, INC.
 FORM 10-K
 TABLE OF CONTENTS

	Page
<u>Part I</u>	
<u>ITEM 1.</u>	<u>Business</u> 3
<u>ITEM 1A.</u>	<u>Risk Factors</u> 15
<u>ITEM 1B.</u>	<u>Unresolved Staff Comments</u> 29
<u>ITEM 2.</u>	<u>Properties</u> 29
<u>ITEM 3.</u>	<u>Legal Proceedings</u> 29
<u>ITEM 4.</u>	<u>Mine Safety Disclosures</u> 29
<u>Part II</u>	
<u>ITEM 5.</u>	<u>Market for the Registrant's Common Equity, Related Stockholder Matters, and Issuer Purchases of Equity Securities</u> 30
<u>ITEM 6.</u>	<u>Selected Financial Data</u> 33
<u>ITEM 7.</u>	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u> 34
<u>ITEM 7A.</u>	<u>Quantitative and Qualitative Disclosures about Market Risk</u> 76
<u>ITEM 8.</u>	<u>Financial Statements and Supplementary Data</u> 78
<u>ITEM 9.</u>	<u>Changes in and Disagreements with Accountants on Accounting and Financial Disclosure</u> 138
<u>ITEM 9A.</u>	<u>Controls and Procedures</u> 138
<u>ITEM 9B.</u>	<u>Other Information</u> 140
<u>Part III</u>	
<u>ITEM 10.</u>	<u>Directors, Executive Officers, and Corporate Governance</u> 140
<u>ITEM 11.</u>	<u>Executive Compensation</u> 141
<u>ITEM 12.</u>	<u>Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters</u> 141
<u>ITEM 13.</u>	<u>Certain Relationships and Related Transactions and Director Independence</u> 141
<u>ITEM 14.</u>	<u>Principal Accountant Fees and Services</u> 141
<u>Part IV</u>	
<u>ITEM 15.</u>	<u>Exhibits and Financial Statement Schedules</u> 142
	<u>Signatures</u> 146

PART I

ITEM 1. BUSINESS

First Midwest Bancorp, Inc.

First Midwest Bancorp, Inc. (the "Company," "we," "us," or "our") is a Delaware corporation incorporated in 1982 and headquartered in the Chicago suburb of Itasca, Illinois. The Company is one of Illinois' largest independent publicly-traded banking companies, with assets of \$9.4 billion as of December 31, 2014, and is registered under the Bank Holding Company Act of 1956, as amended (the "BHC Act"). The Company's common stock, \$0.01 par value per share ("Common Stock"), is listed on the NASDAQ Stock Market and trades under the symbol "FMBI".

Our principal subsidiary, First Midwest Bank (the "Bank"), is an Illinois state-chartered bank and provides a broad range of banking and wealth management services to commercial and industrial, commercial real estate, municipal, and consumer customers primarily throughout the greater Chicago metropolitan area as well as northwest Indiana, central and western Illinois, and eastern Iowa through 109 banking locations. At December 31, 2014, the Company and its subsidiaries employed a total of 1,788 full-time equivalent employees.

History

In 1983, the Company became a bank holding company through the simultaneous acquisition of over 20 affiliated financial institutions. The Bank, through its predecessors, has provided banking and trust services for over 70 years. Since becoming a bank holding company, the Company has grown organically and expanded its market footprint by opening new locations, growing existing locations, and acquiring financial institutions, branches, and non-banking organizations.

In the normal course of business, the Company explores potential opportunities for expansion in core market and adjacent areas through organic growth and the acquisition of banking and non-banking organizations. As a matter of policy, the Company generally does not comment on any dialogue or negotiations with potential targets or possible acquisitions until a definitive acquisition agreement is signed and publicly announced. The Company's ability to engage in certain merger or acquisition transactions, whether or not any regulatory approval is required, will depend on the bank regulators' views at the time as to the capital levels, quality of management, and overall condition of the Company, in addition to their assessment of a variety of other factors.

During 2014, the Bank completed the acquisitions of the Chicago area banking operations of Banco Popular North America ("Popular"), doing business as Popular Community Bank, the equipment lessor National Machine Tool Financial Corporation ("National Machine Tool"), now known as First Midwest Equipment Finance Co., and the south suburban Chicago-based Great Lakes Financial Resources, Inc. ("Great Lakes"), the holding company for Great Lakes Bank, National Association. Additional detail regarding these recent acquisitions is contained in Note 3 of "Notes to the Consolidated Financial Statements" in Item 8 of this Form 10-K.

Subsidiaries

The Company is responsible for the overall conduct, direction, and performance of its subsidiaries. In addition, 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, 2014, the following were the Company's primary subsidiaries:

First Midwest Bank

The Bank conducts operations primarily throughout the greater Chicago metropolitan area, in addition to northwest Indiana, central and western Illinois, and eastern Iowa. The following table presents key figures for the Bank.

(Dollar amounts in thousands)	December 31, 2014
Total assets	\$9,314,575
Total deposits	\$7,933,652
Bank branches	103
Bank offices	6

The Bank operates the following wholly owned subsidiaries:

First Midwest Equipment Finance Co. is an Illinois corporation that provides equipment leasing and commercial financing alternatives to traditional bank financing.

First Midwest Securities Management, LLC is a Delaware limited liability company that manages investment securities.

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

Synergy Property Holdings, LLC is an Illinois limited liability company that manages the majority of the Bank's OREO properties.

First Midwest Holdings, Inc. is a Delaware corporation that manages investment securities, principally municipal obligations, and provides corporate management services to its wholly owned subsidiary, FMB Investments Ltd., a Bermuda corporation. FMB Investments Ltd. manages investment securities and is largely inactive.

Catalyst Asset Holdings, LLC

Catalyst Asset Holdings, LLC, an Illinois limited liability company ("Catalyst"), manages a portion of the Company's non-performing assets. In March of 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. Catalyst had \$6.7 million in non-performing assets remaining as of December 31, 2014.

Catalyst has one wholly owned subsidiary, Restoration Asset Management, LLC ("Restoration"), an Illinois limited liability company that 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.

Parasol Investment Management, LLC

Parasol Investment Management, LLC, a Delaware limited liability company ("Parasol"), began operations in 2011 and is a registered investment advisor under the Investment Advisors Act of 1940. Parasol provides wealth management services to the Bank's wealth management division and to individual and institutional clients, such as corporate and public retirement plans, foundations and endowments, high net worth individuals, and multi-employer trust funds.

First Midwest Capital Trust I, Great Lakes Statutory Trust II, and Great Lakes Statutory Trust III

First Midwest Capital Trust I, a Delaware statutory business trust ("FMCT"), was formed in 2003. Great Lakes Statutory Trust II ("GLST II") and Great Lakes Statutory Trust III ("GLST III") are Delaware statutory business trusts formed in 2005 and 2007, respectively, and were acquired in the Great Lakes acquisition. These trusts were established for the purpose of issuing trust-preferred securities and lending the proceeds to the Company in return for junior subordinated debentures of the Company. The Company guarantees payments of distributions on the trust-preferred securities and payments on redemption of the trust-preferred securities on a limited basis.

FMCT, GLST II, and GLST III qualify as variable interest entities for which the Company is not the primary beneficiary. Consequently, the accounts of those entities are not consolidated in the Company's financial statements. However, the combined \$50.7 million in trust-preferred securities held by the three trusts at December 31, 2014 are included in Tier 1 capital of the Company for regulatory capital purposes.

Segments

The Company has one reportable segment. The Company's chief operating decision maker evaluates the operations of the Company using consolidated information for purposes of allocating resources and assessing performance.

Market Area

The Bank operates in the most active and diverse markets in Illinois, the largest of which is the suburban metropolitan Chicago market, as well as central and western Illinois. The Bank's other service areas are located primarily in northwestern Indiana and eastern Iowa. These service areas include a mixture of urban, suburban, and rural markets and contain a diversified mix of industry groups, including manufacturing, health care, pharmaceutical, higher education, wholesale and retail trade, service, and agricultural.

Competition

The banking and financial services industry in the markets in which the Bank operates (and particularly the Chicago metropolitan area) is highly competitive. 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; credit unions; mutual funds; and investment brokers.

Competition is driven by 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 automated teller machines ("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 wealth management 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 wealth management clients.

Competition is generally based on the variety of products and services offered to clients and the performance of funds under management. The Company's main competitors are financial service providers both within and outside of the geographic areas in which the Bank maintains offices.

The Company faces competition in attracting and retaining qualified employees. Its ability to continue to compete effectively will depend on 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. The Bank has been in the basic business of commercial and retail banking for over 70 years, namely attracting deposits and making loans, as well as providing wealth management services. The Company does not engage in any sub-prime lending, nor does it engage in investment banking activities.

Deposit and Retail Services

The Bank offers a full range of deposit services that are typically available at 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 businesses and residents in the Bank's service areas. The Company's largest category of lending is commercial real estate, followed by commercial and industrial. The mix of properties securing the loans in our commercial real estate portfolio are balanced between owner-occupied and investor categories and are diverse in terms of type and geographic location within the Company's markets. 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 origination are capped at 50% for unimproved land and 65% for developed land. The Company's consumer loans consist primarily of home equity loans and lines of credit and 1-4 family mortgages.

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, 60% of our loan portfolio consisted of real estate-related loans at December 31, 2014.

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 Company's ability to maintain affordable funding sources allows the Bank to meet the credit needs of its customers and the communities it serves. The Bank maintains a relatively stable base of core deposits that are the primary source of the Company's funds for lending and other investment purposes. Deposits funded 84% of the Company's assets at the end of 2014 with a loans-to-deposits ratio of 85%. Consumer, commercial, and public 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, or has the ability to obtain, funds from the amortization, repayment, and prepayment of loans; the sale or maturity of investment securities; certificates of deposits; advances from the Federal Home Loan Bank of Chicago ("FHLB"); securities sold under agreements to repurchase; federal funds purchased; revolving lines of credit from unaffiliated banks; cash flows generated by operations; and proceeds from the issuance of debt and sales of the Company's Common 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 securities portfolio to provide the Company with financial stability, asset diversification, income, and collateral for borrowing. The Company administers its securities portfolio in accordance with an investment policy that was approved and adopted by the Board of Directors of the Bank. The Bank's Asset Liability Committee 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 fully investing available funds, provide adequate regulatory and operational liquidity, minimize and/or adjust the interest rate risk position of the Company, diversify and mitigate 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.

Intellectual Property

Intellectual property is important to the success of our business. We own a variety of trademarks, service marks, trade names, and logos and spend time and resources maintaining our intellectual property portfolio. We control access to our intellectual property through license agreements, confidentiality procedures, non-disclosure agreements with third parties, employment agreements, and other contractual rights to protect our intellectual property.

Supervision and Regulation

The Bank is an Illinois state-chartered bank and a member of the Federal Reserve System, and the Board of Governors of the Federal Reserve System (the "Federal Reserve") has the primary federal authority to examine and supervise the Bank in coordination with the Illinois Department of Financial and Professional Regulation (the "IDFPR"). The Company is a single bank holding company and is also subject to the primary federal bank 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 Federal Deposit Insurance Corporation ("FDIC"), which oversees insured deposits and assets covered by loss share agreements with the FDIC ("the FDIC Agreements"), and the U.S. Department of the Treasury (the "Treasury"), which enforces money laundering and currency transaction regulations. As a public company, the Company is also subject to the regulatory authority of the U.S. Securities and Exchange Commission (the "SEC") and the disclosure and regulatory requirements of the Securities Act of 1933, as amended (the "Securities Act"), and the Securities Exchange Act of 1934, as amended (the "Exchange Act").

Federal and state laws and regulations generally applicable to financial institutions regulate the Company's and the subsidiaries' scope of business, investments, reserves against deposits, capital levels, the nature and amount of collateral for loans, the establishment of branches, mergers, acquisitions, dividends, and other matters. This supervision and regulation is intended primarily for the protection of the FDIC's deposit insurance fund ("DIF"), a bank's depositors, and the stability of the U.S. financial system, 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 federal government's long-term regulatory reform of the financial markets and the implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), which is discussed in more detail later in this Form 10-K. In some cases, the revisions and rulemaking may include a significant overhaul of the regulation of financial institutions or limitations on the products they may offer.

The final regulations, regulatory policies, and regulatory and supervisory guidance applicable to the Company and its subsidiaries, and the manner in which market practices and structures develop around the regulations, could have a material adverse effect on our business, financial condition, and results of operations. The Company cannot accurately predict the nature or the extent of the effects that any such developments will have on its business and earnings. These and other risks are discussed in more detail in Item 1A, "Risk Factors" of this Form 10-K.

Bank Holding Company Act of 1956

Generally, the BHC 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 BHC 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 BHC Act, the Bank Merger Act, and other federal and state statutes regulate acquisitions of commercial banks. The BHC Act requires the prior approval of the Federal Reserve for the direct or indirect acquisition by a bank holding company of more than 5.0% of the voting shares of a commercial bank or its parent holding company. Under the Bank Merger Act, the prior approval of the Federal Reserve or other appropriate bank regulatory authority is required for a member bank to merge with another bank or purchase the assets or assume the deposits of another bank. In reviewing applications seeking approval of merger and acquisition transactions, the bank regulatory authorities will consider, among other things, the competitive effect and public benefits of the transactions, the capital position of the combined organization, the risks to the stability of the U.S. banking or financial system, the applicant's managerial and financial resources, the applicant's performance record under the Community Reinvestment Act and fair housing laws, and the effectiveness of the banks in combating money laundering activities.

In addition, the BHC Act prohibits (with certain exceptions) a bank holding company from acquiring direct or indirect control or ownership, or control of more than 5.0% 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.

Transactions with Affiliates

Any transactions between the Bank and the Company and their respective subsidiaries are regulated by the Federal Reserve. The Federal Reserve's regulations limit the types and amounts of covered transactions engaged in by the Bank and generally require those transactions to be on terms at least as favorable to the Bank as if the transaction were conducted with an unaffiliated third party. Covered transactions are defined by statute to include:

- A loan or extension of credit, as well as a purchase of securities issued by an affiliate.
- The purchase of assets from an affiliate, unless otherwise exempted by the Federal Reserve.
- Certain derivative transactions that create a credit exposure to an affiliate.
- The acceptance of securities issued by an affiliate as collateral for a loan.
- The issuance of a guarantee, acceptance, or letter of credit on behalf of an affiliate.

In general, these regulations require that any extension of credit by the Bank (or its subsidiaries) with an affiliate must be secured by designated amounts of specified collateral and must be limited to certain thresholds on an individual and aggregate basis.

The Bank is also limited as to how much and on what terms it may lend to its insiders and the insiders of its affiliates, including executive officers and directors.

Source of Strength

Federal Reserve policy and federal law require bank holding companies to act as a source of financial and managerial strength to their subsidiary banks. Under this requirement, a 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 such resources. 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. 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 Community Reinvestment Act of 1977, as amended (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, among other things, providing

credit to low-income and moderate-income individuals and communities. Federal regulators conduct CRA examinations on a regular basis 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. Banking regulators take into account CRA ratings when considering approval of a proposed transaction. During its last examination in August of 2012, the Bank received a rating of "outstanding," the highest rating available.

7

Gramm-Leach-Bliley Act of 1999

The Gramm-Leach-Bliley Act of 1999, as amended (the "GLB Act"), allows certain bank holding companies to elect to be treated as a financial holding company (an "FHC") that may 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 Act, the Federal Reserve may not permit a company to register or maintain status as an FHC if the company or any of its insured depository institution subsidiaries are not well-capitalized and well managed. The Federal Reserve may prohibit an FHC from engaging in otherwise permissible activities at its supervisory discretion. In addition, for an FHC to commence any new activity permitted by the BHC Act or to acquire a company engaged in any new activity permitted by the BHC Act, each insured depository institution subsidiary of the FHC must have received a rating of at least "satisfactory" in its most recent examination under the CRA.

In addition, 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 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, terrorist, and other illegal activities. If such activities are detected or suspected, financial institutions are obligated to file suspicious activity reports with the Treasury's Office of Financial Crimes Enforcement Network. These rules require financial institutions to establish procedures for identifying and verifying the identity of customers seeking to open new accounts. Failure to comply with these sanctions could have serious legal and reputational consequences, including causing applicable bank regulatory authorities not to approve merger or acquisition transactions when regulatory approval is required or to prohibit such transactions even if approval is not required.

Office of Foreign Assets Control Regulation

The United States imposes economic sanctions that affect transactions with designated foreign countries, nationals, and others. These sanctions are administered by the Treasury's Office of Foreign Assets Control ("OFAC"). These sanctions include: (i) restrictions on trade with or investment in a sanctioned country, including prohibitions against direct or indirect imports from and exports to a sanctioned country and prohibitions on "U.S. persons" engaging in financial transactions relating to making investments in, or providing investment-related advice or assistance to, a sanctioned country; and (ii) a blocking of assets in which the government or specially designated nationals of the sanctioned country have an interest by prohibiting transfers of property subject to U.S. jurisdiction (including property in the possession or control of U.S. persons). Blocked assets (e.g., property and bank deposits) cannot be paid out, withdrawn, set off, or transferred in any manner without a license from OFAC. Failure to comply with these sanctions could have serious legal and reputational consequences for the institution, including causing applicable bank regulatory authorities not to approve merger or acquisition transactions when regulatory approval is required or to prohibit such transactions even if approval is not required.

Dodd-Frank Wall Street Reform and Consumer Protection Act

The Dodd-Frank Act significantly restructured the financial regulatory regime in the United States. Although the Dodd-Frank Act's provisions that have received the most public attention generally have been those applying to or more likely to affect larger institutions, such as bank holding companies and banks with total consolidated assets of \$10 billion or more, it contains numerous other provisions that affect all bank holding companies and banks, including the Company and the Bank, some of which are described in more detail below. We are monitoring developments with respect to the provisions applicable to bank holding companies and banks with total consolidated assets of \$10 billion or more in the event that the Company or Bank reaches that size.

Some of these provisions may have the consequence of increasing the Company's expenses, decreasing the Company's revenues, and changing the activities in which the Company chooses to engage. Many aspects of the Dodd-Frank Act are still subject to future rulemaking, implementation, and guidance that will occur over several years, making it difficult to anticipate the overall financial impact on the Company, its customers, or the financial industry in general.

Consumer Financial Protection

The Dodd-Frank Act created the Consumer Financial Protection Bureau ("CFPB") as a new and independent unit within the Federal Reserve System. With certain exceptions, the CFPB has authority to regulate any person or entity that engages in offering or providing a "consumer financial product or service" and has rulemaking, examination, and enforcement powers over financial institutions. For primary examination and enforcement authority of financial entities, however, the CFPB's authority is limited to institutions with assets of \$10 billion or more. Existing regulators retain this authority over institutions with assets of \$10 billion or less, such as the Company.

The powers of the CFPB currently include:

- The ability to prescribe consumer financial laws and rules that regulate all institutions that engage in offering or providing a consumer financial product or service.

- Primary enforcement and exclusive supervision authority for federal consumer financial laws over "very large" insured institutions with assets of \$10 billion or more. This includes the right to obtain information about an institution's activities and compliance systems and procedures and to detect and assess risks to consumers and markets.

- The ability to require reports from institutions with assets under \$10 billion, such as the Bank, to support the CFPB in implementing federal consumer financial laws, supporting examination activities, and assessing and detecting risks to consumers and financial markets.

- Examination authority (limited to assessing compliance with federal consumer financial laws) over institutions with assets under \$10 billion, such as the Bank. Specifically, a CFPB examiner may be included on a sampling basis in the examinations performed by the institution's primary regulator.

The CFPB engages in several activities including (i) investigating consumer complaints about credit cards and mortgages, (ii) launching supervisory programs, (iii) conducting research for and developing mandatory financial product disclosures, and (iv) engaging in consumer financial protection rulemaking.

The Bank is also 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, the Bank is subject to the Federal Truth in Savings Act, the Home Mortgage Disclosure Act, and the Real Estate Settlement Procedures Act. Electronic banking activities are subject to federal law, including the Electronic Funds Transfer Act. Wealth management activities of the Bank are subject to the Illinois Corporate Fiduciaries Act. Loans made by the Bank are subject to applicable provisions of the Federal Truth in Lending Act. Other consumer financial laws include the Equal Credit Opportunity Act, Fair Credit Reporting Act, Fair Debt Collection Practices Act, and applicable state laws.

The Federal Reserve has primary responsibility for examination and enforcement of federal consumer financial laws with respect to the Company, and state authorities are responsible for monitoring the Company's compliance with all state consumer laws. Failure to comply with these requirements could have serious legal and reputational consequences for the institution, including causing applicable bank regulatory authorities not to approve merger or acquisition transactions when regulatory approval is required or to prohibit such transactions even if approval is not required.

Interchange Fees

Under the Durbin Amendment of the Dodd-Frank Act, the Federal Reserve established a maximum permissible interchange fee equal to no more than 21 cents plus five basis points of the transaction value for many types of debit interchange transactions. The Federal Reserve also adopted a rule to allow a debit card issuer to recover one cent per transaction for fraud prevention purposes if the issuer complies with certain fraud-related requirements required by the Federal Reserve. The Company is in compliance with these fraud-related requirements. The Federal Reserve also has rules governing routing and exclusivity that require issuers to offer two unaffiliated networks for routing transactions on each debit or prepaid product.

Currently, the Company is exempt from the interchange fee cap under the "small issuer" exemption, which applies to any debit card issuer with total worldwide assets of less than \$10 billion as of the end of the previous calendar year. In the event the Company's assets reach \$10 billion or more, it will become subject to the interchange fee limitations

beginning July 1 of the following year, and the fees the Company may receive for an electronic debit transaction will be capped at the statutory limit.

9

Capital Requirements

The Federal Reserve and other federal bank regulators 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 by the regulatory authorities. These guidelines require banking institutions to maintain capital based on the 1988 capital accord ("Basel I") of the Basel Committee on Banking Supervision (the "Basel Committee").

The Basel Committee is a committee of central banks and bank supervisors/regulators from the major industrialized countries that develops broad policy guidelines for use by each country's supervisors in determining the supervisory policies they apply. The requirements are intended to ensure that banking organizations have adequate capital given the risk levels of assets and off-balance sheet financial instruments ("risk-weighted assets").

Capital is classified in one of the following tiers:

Core Capital (Tier 1). Tier 1 capital includes common equity, retained earnings, qualifying non-cumulative perpetual preferred stock, a limited amount of qualifying cumulative perpetual stock at the holding company level, minority interests in equity accounts of consolidated subsidiaries, and qualifying trust-preferred securities, less goodwill, most intangible assets, and certain other assets.

Supplementary Capital (Tier 2). Tier 2 capital includes perpetual preferred stock and trust-preferred securities not meeting the Tier 1 definition, qualifying mandatory convertible debt securities, qualifying subordinated debt, and the allowance for credit losses, subject to limitations.

Regulatory requirements also establish quantitative measures to ensure capital adequacy for banking institutions as follows:

	Adequately Capitalized Requirement	Well-Capitalized Requirement
Tier 1 capital to risk-weighted assets	4.00%	6.00%
Total capital to risk-weighted assets	8.00%	10.00%
Tier 1 capital to average assets	4.00%	5.00%

Basel III Capital Rules

In July 2013, the Federal Reserve published final rules (the "Basel III Capital Rules") establishing a new comprehensive capital framework for U.S. banking organizations. The rules implement the Basel Committee's December 2010 framework commonly known as "Basel III" for strength