FIRST MIDWEST BANCORP INC
Form 10-K
February 27, 2009
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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, 2008**

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. [X].

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, 2008, determined using a per share closing price on that date of $18.65, as quoted on The Nasdaq Stock Market, was $825,612,542.

At February 26, 2009 there were 48,630,531 shares of common stock, $.01 par value, outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of Registrant s Proxy Statement for the 2009 Annual Stockholders Meeting - Part III

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First Midwest Bancorp, Inc. 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 truly fulfill those financial needs.

AVAILABLE INFORMATION

We file annual, quarterly, and current reports; proxy statements; and other information with the 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*. 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.

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, as well as 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 some cases, you can identify these statements by forward-looking words such as may, might, will, should, expect, plan, anticipate, believe, estimate, predict, potential, or continue, and the negative of these terms and other comp terminology. We caution you not to 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 include 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 Items 1A and 7 of this Annual Report on Form 10-K, including the sections entitled Risk Factors and Management s Discussion and Analysis of Results of Operations, as well as our subsequent periodic and current reports filed with the SEC. These risks and uncertainties are not exhaustive, however. Other sections of this report describe additional factors that could adversely impact our business and financial performance.

Since mid-2007, and particularly during the second half of 2008, the financial services industry and the securities markets generally have been materially and adversely affected by significant declines in the values of nearly all asset classes and by a serious lack of liquidity. The global markets have been characterized by substantially increased volatility and short-selling and an overall loss of investor confidence, initially in financial institutions, but more recently in companies in a number of other industries and in the broader markets. Such instability 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 very 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.

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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 $8.5 billion as of December 31, 2008 and is headquartered in the Chicago suburb of Itasca, Illinois.

History

The Company is the product of the consolidation of over 26 affiliated banks 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 $645.6 million institution in 2003, and Bank Calumet, Inc., a $1.4 billion institution in 2006. The Company continues to explore opportunities to acquire banking institutions and discussions related to possible acquisitions may occur at any time. The Company cannot predict whether, or on what terms, communications will result in further acquisitions. 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 operates two wholly owned subsidiaries: First Midwest Bank (the Bank), employing 1,794 full-time equivalent employees at December 31, 2008, and First Midwest Insurance Company. Substantially all of the Company s operations are conducted through the Bank. At December 31, 2008, the Bank had $8.5 billion in total assets, $5.8 billion in total deposits, and 98 banking offices primarily in suburban metropolitan Chicago.

The Bank operates the following wholly owned subsidiaries:

- FMB Investment Corporation is a Delaware corporation established in 1998 that manages investment securities, principally state and municipal obligations, and provides corporate management services to its wholly owned subsidiary, FMB Investment Trust, a Maryland business trust, also established in 1998. FMB Investment Trust manages many of the real estate loans originated by the Bank. FMB Investment Trust has elected to be taxed as a Real Estate Investment Trust for federal income tax purposes.
- Calumet Investment Corporation is a Delaware corporation that manages investment securities, principally state and 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.
- First Midwest Investments, Inc. and Bank Calumet Financial Services, Inc. are largely inactive.

First Midwest Insurance Company operates as a reinsurer of credit life, accident, and health insurance sold through the Bank, primarily in conjunction with its consumer lending operations, and is largely inactive.

The Company has responsibility 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.

Market Area

First Midwest s largest service area is the suburban Chicago metropolitan market, which includes the counties surrounding Cook County, Illinois. This area extends from the cities of Zion and Waukegan, Illinois down into northwest Indiana, including the cities of Crown Point and St. John, Indiana. The Company s other service areas consist of a central Illinois market, which includes the cities of Champaign, Danville, and Galesburg, and an Iowa, or Quad-Cities market, which includes the cities of Davenport, Bettendorf, Moline, and East Moline. These service areas include a mixture of urban, suburban, and rural markets. First Midwest 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.

The Chicago metropolitan area currently ranks 3rd in the nation with respect to total businesses, 3rd in total population, 11th in average household income, and 8th 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, 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, and it expects to face increasing competition from on-line banking and financial institutions seeking to attract customers by providing access to services and products that mirror the services and products offered by traditional brick-and-mortar institutions.

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

First Midwest 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, First Midwest has been in the basic business of community banking, namely attracting deposits and making loans, as well as providing wealth management, investment, and retirement plan services. The Company does not engage in any sub-prime or speculative lending, nor does it engage in non-commercial banking activities such as investment banking services or loan securitizations.

First Midwest differentiates itself from other commercial banks and financial institutions by the way it systematically assesses a customer s specific financial needs, sells products and services to meet those needs, and provides the customer with high quality service. The Company believes this approach and its knowledge of and commitment to the communities in which it is located are the most important aspects in retaining and expanding its customer base.

Deposit and Retail Services

First Midwest 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 IRAs.

Lending Activities

First Midwest originates commercial and industrial, agricultural, commercial real estate, and consumer loans. Substantially all of the Company s borrowers are residents of First Midwest s principal markets. The Company s largest category of lending is commercial real estate (including residential land and development 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 for unimproved and developed land at time of issuance historically have been 65% and 75%, respectively. Given current market conditions, these ratios have been lowered to 50% and 65%, respectively. The Company s consumer loans consist primarily of home equity loans and lines of credit. 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.

First Midwest Sources of Funds

First Midwest s ability to maintain affordable funding sources allows the Company to meet the credit needs of its customers and the communities it serves. Deposits are a relatively stable form of funding, and they are the primary source of the Company s funds for lending and other investment purposes. Core deposits funded approximately 40% of the Company s assets at the end of 2008, with a net loan-to-deposit ratio of 96%. 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, brokered repurchase agreements and certificates of deposits, federal funds purchased, and federal term auction facilities; cash flows generated by operations; and proceeds from sale 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.

First Midwest Investment Activities

First Midwest 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 First Midwest s investment activities are, among other things, 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.

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Participation in Government Economic Recovery Programs

In response to the recent financial market crisis, the United States government, specifically the U.S. Department of the Treasury (Treasury), the Board of Governors of the Federal Reserve System (Federal Reserve), and the Federal Deposit Insurance Corporation (FDIC), working in cooperation with foreign governments and other central banks, has taken a variety of extraordinary measures designed to restore confidence in the financial markets and to strengthen financial institutions, including measures available under the *Emergency Economic Stabilization Act of 2008* (EESA), which was enacted by the U.S. Congress in October of 2008. These measures include capital injections, guarantees of bank liabilities, and the potential acquisition of illiquid assets from banks. Below are summaries of certain federal economic recovery programs, including programs in which First Midwest participates:

- *Increase in FDIC Deposit Insurance*. The EESA increases the maximum deposit insurance amount up to $250,000 until December 31, 2009 and removes the statutory limits on the FDIC s ability to borrow from the Treasury during this period. The Company held no such investment in either the Federal National Mortgage Association or Federal Home Loan Mortgage Corporation.
- *Capital Purchase Program*. Under the EESA, the Treasury may take a range of actions to provide liquidity to the U.S. financial markets, including the direct purchase of equity of financial institutions through the Treasury s Capital Purchase Plan (CPP). The Company elected to participate in the CPP, and on December 5, 2008, First Midwest issued to the Treasury, in exchange for aggregate consideration of $193.0 million, (1) 193,000 shares of the Company s Fixed Rate Cumulative Perpetual Preferred Stock, Series B, liquidation preference of $1,000 per share (Preferred Shares); and (2) a ten-year warrant (Warrant) to purchase up to 1,305,230 shares of the Company s common stock, par value $0.01 per share (Common Stock) at an exercise price, subject to anti-dilution adjustments, of $22.18 per share. Cumulative dividends on the Preferred Shares will accrue on the liquidation preference at a rate of 5% per annum for the first five years and at a rate of 9% per annum thereafter. The securities were sold in a private placement exempt from registration pursuant to Section 4(2) of the Securities Act of 1933, as amended. The Preferred Shares generally are nonvoting and qualify as Tier 1 capital.

The letter agreement between the Treasury and the Company, dated December 5, 2008, including the securities purchase agreement concerning the issuance and sale of the Preferred Shares (the Purchase Agreement), grants the holders of the Preferred Shares, the Warrant, and First Midwest common stock to be issued under the Warrant certain registration rights and imposes restrictions on dividends and stock repurchases. In addition, in the event that the Company fails to declare and pay full dividends (or declare and set aside a sum sufficient for payment thereof) on the Preferred Shares, the Purchase Agreement will impose restrictions on the Company s ability to declare or pay dividends or distributions on, or repurchase, redeem, or otherwise acquire for consideration, shares of its junior stock. For a detailed description of these restrictions, see Item 1A, Risk Factors, elsewhere in this report. In addition, the Purchase Agreement subjects the Company to the executive compensation limitations as set forth in Section 111(b) of the EESA.

- *Temporary Liquidity Guarantee Program (TLGP)*. Under the TLGP, the FDIC will temporarily provide a 100% guarantee of the deposits in non-interest-bearing transaction deposit accounts in participating financial institutions. The Company participates in this program. Consequently, all funds held in non-interest-bearing transaction accounts (demand deposit accounts), Interest on Lawyers Trust Accounts (IOLTAs), and low-interest NOW accounts (defined as NOW accounts with interest rates no higher than 0.50%) with the Bank are covered under this program.

The TLGP also provides a three-year 100% guarantee of any newly issued senior unsecured debt that could be issued by the Company on or before June 30, 2009 (including promissory notes, commercial paper, inter-bank funding, and any unsecured portion of secured debt). The amount of potential Company debt that could be covered by this guarantee may not exceed 125% of the Company s debt that was both outstanding as of September 30, 2008 and scheduled to mature before June 30, 2009. All fees associated with this guarantee are waived for the first 30 days of coverage. After the first 30 days, an annualized fee equal to 75 basis points multiplied by the amount of debt issued under this program is imposed.

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Temporary Guarantee Program for Money Market Funds. Under the Temporary Guarantee Program for Money Market Funds, the Treasury will guarantee the share price of any publicly offered eligible money market mutual fund, both retail and institutional, that applies for and pays a fee to participate in the program. The temporary guarantee applies to all money market mutual funds that are regulated under Rule2a-7 of the Investment Company Act of 1940, are publicly offered, are registered with the SEC, and maintain a stable share price of $1. This includes both taxable and non-taxable funds. While the program protects the shares of all money market fund investors as of September 19, 2008, each money market fund makes the decision to sign up for the program. Company vendors have advised the Company that the funds in which balances from sweep accounts have been invested are enrolled in this program.

Purchase of Troubled Assets. The EESA authorizes the Treasury to purchase up to $700 billion in troubled assets from financial institutions under the Treasury s Troubled Assets Relief Program (TARP). Troubled assets include residential or commercial mortgages and related instruments originated prior to March 14, 2008 and any other financial instrument that the Secretary of the Treasury determines, after consultation with the Chairman of the Federal Reserve, the purchase of which is necessary to promote financial stability. If the Secretary exercises authority under TARP, the EESA directs the Secretary to establish a program to guarantee troubled assets originated or issued prior to March 14, 2008. The Treasury currently has not initiated any purchases under this program. If, and when, they do, the Company may or may not be eligible to participate in this program.

In addition to the government programs and legislation listed above, additional programs and legislation intended to address the current economic environment and financial crisis may be proposed or passed in the future. In this event, we could become subject to new rules and regulations or participate in additional government programs.

For example, on February 10, 2009, the Treasury Secretary introduced the framework for its Financial Stability Plan (FSP). As proposed, this plan may impose restrictions on financial institutions or mandate their participation in certain programs designed to strengthen the financial system or provide aid to homeowners and small businesses. In addition, on February 17, 2009, President Obama signed into law the American Recovery and Reinvestment Act of 2009, a $787 billion stimulus bill for the purpose of stabilizing and stimulating the economy, which imposes restrictions on CPP participants including the Company. Certain of these restrictions are discussed in greater detail under the heading, Supervision and Regulation - Executive Compensation Limitations.

First Midwest cannot predict whether or when the FSP or any other new government programs or legislation will be adopted. First Midwest also cannot predict whether the FSP will be adopted in its current proposed form or in a different form.

Supervision and Regulation

The Company and its subsidiaries are subject to regulation and supervision by various governmental regulatory authorities including the Board of Governors of the Federal Reserve System (the Federal Reserve), the Federal Deposit Insurance Corporation (the FDIC), the Illinois Department of Financial and Professional Regulation (the IDFPR), and the Arizona Department of Insurance. Financial institutions and their holding companies are extensively regulated under federal and state law.

Federal and state laws and regulations generally applicable to financial institutions, such as the Company and its subsidiaries, regulate, among other things, the scope of business, investments, reserves against deposits, capital levels, the nature and amount of collateral for loans, the establishment of branches, mergers, consolidations, and dividends. 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 references to material statutes and regulations affecting the Company and its subsidiaries are brief summaries thereof and are qualified in their entirety by reference to such statutes and regulations. Any change in applicable law or regulations may have a material effect on the business or operations of the Company and its subsidiaries. The operations of the Company may also be affected by changes in the policies of various regulatory authorities. The Company cannot accurately predict the nature or the extent of the effects that any such changes would have on its business and earnings.

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

Generally, the Act governs the acquisition and control of banks and nonbanking companies by bank holding companies. A bank holding company is subject to regulation under the Act and is required to register with the Federal Reserve under the Act. 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 and is subject, along with its subsidiaries, to examination by the Federal Reserve. The Federal Reserve has 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 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. The Federal Reserve evaluates acquisition applications based on, among other things, competitive factors, supervisory factors, adequacy of financial and managerial resources, and banking and community needs considerations.

The Act also prohibits, 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 nonbanking company unless the nonbanking 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 nonbank subsidiaries are permitted, among other activities, to engage in such banking-related business ventures as consumer finance, equipment leasing, data processing, mortgage banking, financial and investment advice, and securities brokerage services. The Act does not place territorial restrictions on the activities of a bank holding company or its nonbank subsidiaries.

Federal law prohibits acquisition of control of a bank or bank holding company without prior notice to certain federal bank regulators. Control is defined in certain cases as the acquisition of as little as 10% of the outstanding shares of any class of voting stock. Furthermore, under certain circumstances, a bank holding company may not be able to purchase its own stock, where the gross consideration will equal 10% or more of the company s net worth, without obtaining approval of the Federal Reserve. Under the Federal Reserve Act, banks and their affiliates are subject to certain requirements and restrictions when dealing with each other (affiliate transactions including transactions with their bank holding company). The Company is also subject to the provisions of the Illinois Bank Holding Company Act.

Interstate Banking

Bank holding companies are permitted to acquire banks and bank holding companies in any state and to be acquired, subject to the requirements of Riegle-Neal and, in some cases, applicable state law.

Under Riegle-Neal, adequately capitalized and managed bank holding companies may be permitted by the Federal Reserve to acquire control of a bank in any state. States, however, may prohibit acquisitions of banks that have not been in existence for at least five years. The Federal Reserve is prohibited from approving an application for acquisition if the applicant controls more than 10% of the total amount of deposits of insured depository institutions nationwide. In addition, interstate acquisitions may also be subject to statewide concentration limits.

The Federal Reserve would be prohibited from approving an application if, prior to consummation, the proposed acquirer controls any insured depository institution or branch in the home state of the target bank, and the applicant, following consummation of an acquisition, would control 30% or more of the total amount of deposits of insured depository institutions in that state. This legislation also provides that the provisions on concentration limits do not affect the authority of any state to limit or waive the percentage of the total amount of deposits in the state which would be held or controlled by any bank or bank holding company to the extent the application of this limitation does not discriminate against out-of-state institutions.

Interstate branching under Riegle-Neal permits banks to merge across state lines, thereby creating a bank headquartered in one state with branches in other states. Approval of interstate bank mergers is subject to certain conditions including adequate capitalization, adequate management, Community Reinvestment Act compliance, deposit concentration limits (as set forth above), compliance with federal and state antitrust laws, and compliance with applicable state consumer protection laws. An interstate merger transaction may involve the acquisition of a branch without the acquisition of the bank only if the law of the state in which the branch is located permits out-of-state banks to acquire a branch of a bank in that state without acquiring the bank. Following the consummation of an interstate transaction, the resulting bank may establish additional branches at any location where any bank involved in the transaction could have established a branch under applicable federal or state law, if such bank had not been a party to the merger transaction.

Riegle-Neal allowed each state the opportunity to opt out, thereby prohibiting interstate branching within that state. Of the three states in which the Bank is located (Illinois, Indiana, and Iowa), none of them has adopted legislation to opt out of the interstate merger provisions. Furthermore, pursuant to Riegle-Neal, a bank is able to add new branches in a state in which it does not already have banking operations if such state enacts a law permitting such de novo branching, or, if the state allows acquisition of branches, subject to applicable state requirements. Illinois law allows de novo banking with other states that allow Illinois banks to branch de novo in those states.

Illinois Banking Law

The Illinois Banking Act (IBA) governs the activities of the Bank, an Illinois banking corporation. The IBA defines the powers and permissible activities of an Illinois state-chartered bank, prescribes corporate governance standards, imposes approval requirements on mergers of state banks, prescribes lending limits, and provides for the examination of state banks by the IDFPR. The Banking on Illinois Act (BIA) became effective in mid-1999 and amended the IBA to provide a wide range of new activities allowed for Illinois state-chartered banks, including the Bank. The provisions of the BIA are to be construed liberally in order to create a favorable business climate for banks in Illinois. The main features of the BIA are to expand bank powers through a wild card provision that authorizes Illinois state-chartered banks to offer virtually any product or service that any bank or thrift may offer anywhere in the country, subject to restrictions imposed on those other banks and thrifts, certain safety and soundness considerations, and prior notification to the IDFPR and the FDIC.

Federal Reserve Act

The Bank is subject to Sections 23A and 23B of the Federal Reserve Act, which restrict or impose requirements on financial transactions between federally insured depository institutions and affiliated companies. The statute limits 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.

Other Regulation

The Bank is subject to a variety of federal and state laws and regulations governing its operations. 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.

The Bank is also subject to a variety of other laws and regulations concerning equal credit opportunity, fair lending, customer privacy, identity theft, fair credit reporting, and community reinvestment. The Bank currently holds an outstanding rating for community reinvestment activity, the highest available.

As an Illinois banking corporation controlled by a bank holding company, the Bank is subject to the rules regarding change of control in the Act and the Federal Deposit Insurance Act and is also subject to the rules regarding change in control of Illinois banks contained in the IBA and the Illinois Bank Holding Company Act.

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

The GLB Act allows for banks, other depository institutions, insurance companies, and securities firms to enter into combinations that permit a single financial services organization to offer customers a more comprehensive array of financial products and services. The GLB Act defines a financial holding company (FHC), which is regulated by the Federal Reserve. Functional regulation of the FHC s subsidiaries is conducted by their primary functional regulators. Pursuant to the GLB Act, bank holding companies, foreign banks, and their subsidiary depository institutions electing to qualify as an FHC must be well managed, well capitalized, and rated at least satisfactory under the Community Reinvestment Act in order to engage in new financial activities.

An FHC may engage in securities and insurance activities and other activities that are deemed financial in nature or incidental to a financial activity under the GLB Act, such as merchant banking activities. While aware of the flexibility of the FHC statute, the Company has, for the time being, decided not to become an FHC. The activities of bank holding companies that are not FHCs will continue to be regulated by, and limited to, activities permissible under the Act.

The GLB Act also prohibits a financial institution from disclosing 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.

The Bank is also subject to certain federal and state laws that limit the use and distribution of non-public personal information to subsidiaries, affiliates, and unaffiliated entities.

Bank Secrecy Act and USA Patriot Act

In 1970, Congress enacted the Currency and Foreign Transactions Reporting Act, commonly known as the Bank Secrecy Act (the BSA). The BSA requires financial institutions to maintain records of certain customers and currency transactions and to report certain domestic and foreign currency transactions, which may have a high degree of usefulness in criminal, tax, or regulatory investigations or proceedings. Under this law, financial institutions are required to develop a BSA compliance program.

In 2001, the President signed into law comprehensive anti-terrorism legislation known as the USA Patriot Act. Title III of the USA Patriot Act requires financial institutions, including the Company and the Bank, to help prevent and detect international money laundering and the financing of terrorism and prosecute those involved in such activities. The Department of the Treasury has adopted additional requirements to further implement Title III.

Under these regulations, a mechanism has been established for law enforcement officials to communicate names of suspected terrorists and money launderers to financial institutions to enable financial institutions to promptly locate accounts and transactions involving those suspects. Financial institutions receiving names of suspects must search their account and transaction records for potential matches and report positive results to the U.S. Department of the Treasury Financial Crimes Enforcement Network (FinCEN). Each financial institution must designate a point of contact to receive information requests. These regulations outline how financial institutions can share information concerning suspected terrorist and money laundering activity with other financial institutions under the protection of a statutory safe harbor if each financial institution notifies FinCEN of its intent to share information.

The Department of the Treasury has also adopted regulations intended to prevent money laundering and terrorist financing through correspondent accounts maintained by U.S. financial institutions on behalf of foreign banks. Financial institutions are required to take reasonable steps to ensure that they are not providing banking services directly or indirectly to foreign shell banks.

In addition, banks must have procedures in place to verify the identity of the persons with whom they deal.

Capital Guidelines

The Federal Reserve and the 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 as well as in the analysis of applications to be acted upon by the regulatory authorities. These guidelines require banking institutions to maintain capital based on the credit risk of their operations, both on and off-balance sheet.

The minimum capital ratios established by the guidelines are based on both tier 1 and total capital to total risk-based assets (as defined in the regulations). In addition to the risk-based capital requirements, the Federal Reserve and the FDIC require banking institutions to maintain a minimum leveraged-capital ratio to supplement the risk-based capital guidelines. The Company and the Bank are well capitalized by these standards, the highest applicable ratings.

Dividends

The Company s primary source of liquidity is dividend payments from the Bank. In addition to capital guidelines, the Bank is limited in the amount of dividends it can pay to the Company under the IBA. Under this law, the Bank is permitted to declare and pay dividends in amounts up to the amount of its accumulated net profits, provided that it retains in its surplus at least one-tenth of its net profits since the date of the declaration of its most recent dividend until those additions to surplus, in the aggregate, equal the paid-in capital of the Bank. The Bank may not, while it continues its banking business, pay dividends in excess of its net profits then on hand (after deductions for losses and bad debts). In addition, the Bank is limited in the amount of dividends it can pay under the Federal Reserve Act and Regulation H. For example, dividends cannot be paid that would constitute a withdrawal of capital; dividends cannot be declared or paid if they exceed a bank s undivided profits; and a bank may not declare or pay a dividend greater than current year net income plus retained net income of the prior two years without Federal Reserve approval.

Since the Company is a legal entity, separate and distinct from the Bank, its dividends to stockholders are not subject to the bank dividend guidelines discussed above. The IDFPR is authorized to determine, under certain circumstances relating to the financial condition of a bank or bank holding company, that the payment of dividends by the Company would be an unsafe or unsound practice and to prohibit payment thereof. The Federal Reserve has taken the position that dividends that would create pressure or undermine the safety and soundness of the subsidiary bank are inappropriate.

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FDIC Insurance Premiums

The Bank s deposits are insured through the DIF, which is administered by the FDIC. As insurer, the FDIC imposes deposit insurance premiums and is authorized to conduct examinations of, and to require reporting by, FDIC-insured institutions. It also may prohibit any FDIC-insured institution from engaging in any activity the FDIC determines by regulation or order to pose a serious risk to the DIF.

The FDIC s deposit insurance premiums are assessed through a risk-based system under which all insured depository institutions are placed into one of four categories and assessed insurance premiums on deposits based on their level of capital and supervisory evaluation. For 2009, the Bank will pay premium assessments on its DIF-insured deposits in order to service the interest on the Financing Corporation (FICO) bond obligations, which were used to finance the cost of thrift bailouts in the 1980 s. The FICO assessment rates for the first quarter of 2009 were set at $0.0114 per $100 of insured deposits for DIF-assessable deposits. These rates may be adjusted quarterly to reflect changes in assessment basis for the DIF.

Sarbanes-Oxley Act of 2002

The Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley) implemented a broad range of corporate governance and accounting measures to increase corporate responsibility, to provide for enhanced penalties for accounting and auditing improprieties at publicly traded companies, and to protect investors by improving the accuracy and reliability of disclosures under federal securities laws. The Company is subject to Sarbanes-Oxley because it is required to file periodic reports with the SEC under the Securities and Exchange Act of 1934. Among other things, Sarbanes-Oxley and/or its implementing regulations have established new membership requirements and additional responsibilities for the Company s audit committee, imposed restrictions on the relationship between the Company and its outside auditors (including restrictions on the types of non-audit services our auditors may provide to us), imposed additional responsibilities for external financial statements on our chief executive officer and chief financial officer, expanded the disclosure requirements for corporate insiders, required management to evaluate the Company s disclosure controls and procedures and our internal control over financial reporting, and required auditors to issue a report on the Company s internal control over financial reporting. The Nasdaq Stock Market has imposed a number of new corporate governance requirements as well.

Executive Compensation Limitations

Incident to its participation in the CPP, the Company is subject to the executive compensation limitations contained in Section 111(b) of the EESA. These limitations apply to the Company s senior executive officers (SEOs), which include the Company s principal executive officer, the principal financial officer, and the three most highly compensated executive officers. These limitations include: (1) the recovery of any bonus or incentive compensation paid to any SEO if the financial criteria it was based on was later proven to be materially inaccurate; (2) a prohibition on the Company making golden parachute payments (as defined by IRS Section 280(G)) to any SEO; (3) a prohibition on compensation that encourages any SEO to take unnecessary and excessive risks that threaten the value of the Company; and (4) a limit on deductible compensation under Section 162(m) of the Internal Revenue Code for each SEO at $500,000 annually, rather than $1 million.

In addition, the Company s Compensation Committee must certify that it has: (1) within 90 days after the CPP purchase reviewed the SEO incentive and bonus compensation programs for unnecessary and excessive risks; and (2) met at least annually with the senior risk officers to review the relationship between the institution s risk management policies and the SEO incentive compensation arrangements.

In addition to the EESA s executive compensation limitations, on February 17, 2009, President Obama signed into law the American Recovery and Reinvestment Act of 2009 (the ARRA), a $787 billion stimulus bill for the purpose of stabilizing and stimulating the economy. The ARRA imposes certain new executive compensation and corporate expenditure limits on all current and future TARP CPP participants including the Company. These limits include:

- Prohibition on certain bonus, retention, incentive compensation, and golden parachute payments for certain senior employees.

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- Required adoption of a policy on excessive or luxury expenditures.
- Mandated say on pay shareholder vote on the compensation of executives.
- Requirement of an annual certification by the CEO and CFO of the Company s compliance with the ARRA restrictions.

The AARA also empowers the Treasury Secretary with the authority to review bonus, retention, and other compensation paid to senior executive officers that have received the TARP assistance to determine if the compensation was inconsistent with the purposes of the ARRA or TARP, or otherwise contrary to the public interest and, if so, seek to negotiate reimbursements. The provision of the ARRA will apply to the Company until it has redeemed the securities sold to the Treasury under the CPP. (See the section captioned Participation in Government Economic Recovery Programs Capital Purchase Program in Part I, Item 1 of this Form 10-K.) Under the ARRA such redemption is now permitted without penalty and without the need to raise new capital (as was required under the terms of the original TARP CPP), subject to the Treasury s consultation with the recipient s appropriate regulatory agency.

Future Legislation

Various legislation is currently being considered by Congress. This legislation may change banking statutes and the Company s operating environment in substantial and unpredictable ways and may increase reporting requirements and governance. If enacted, such legislation could increase or decrease the cost of doing business, limit or expand permissible activities, or affect the competitive balance among banks, savings associations, credit unions, and other financial institutions. The Company cannot predict whether any potential legislation will be enacted and, if enacted, the effect that it, or any implementing regulations, would have on its business, results of operations, or financial condition.

ITEM 1A. RISK FACTORS

The material risks and uncertainties that management believes affect the Company are described below. Before making an investment decision with respect to any of the Company s securities, you should carefully consider the risks and uncertainties as described below together with all of the information included herein. The risks and uncertainties described below are not the only risks and uncertainties the Company faces. Additional risks and uncertainties not presently known or that are currently deemed immaterial also may have a material adverse effect on the Company s results of operations and financial condition. If any of the following risks actually occur, the Company s results of operations and financial condition could suffer, possibly materially. In that event, the trading price of the Company s common stock or other securities could decline. The risks discussed below also include forward-looking statements, and actual results may differ substantially from those discussed or implied in these forward-looking statements.

Risks Related to the Company s Business

The Company s Business May Be Adversely Affected by Conditions in the Financial Markets and Economic Conditions Generally

Since December 2007, the United States has been in a downward cycle. Prolonged and significant weakness has adversely impacted all aspects of the economy. Business activity across a wide range of industries and regions is greatly reduced, and local governments and many businesses are experiencing serious difficulty due to the lack of consumer spending and the lack of liquidity in the credit markets. In addition, unemployment has increased significantly and continues to grow.

Since mid-2007, and particularly during the second half of 2008, the financial services industry and the securities markets generally were materially and adversely affected by significant declines in the values of nearly all asset classes and by a serious lack of liquidity. This was initially triggered by declines in home prices and the values of sub-prime mortgages but spread to all mortgage and real estate asset classes, leveraged bank loans, and nearly all other asset classes, including equities. The global markets have been characterized by substantially increased volatility and short-selling and an overall loss of investor confidence, initially in financial institutions, but more recently in companies in a number of other industries and in the broader markets.

Market conditions have also led to the failure or merger of a number of prominent financial institutions. Financial institution failures or near-failures have resulted in further losses as a consequence of defaults on securities issued by them and defaults under contracts entered into with such entities as counterparties. Furthermore, declining asset values, defaults on mortgages and consumer loans, the lack of market and investor confidence, and other factors have all combined to cause rating agencies to lower credit ratings and to otherwise increase the cost and decrease the availability of liquidity, despite very significant declines in Federal Reserve borrowing rates and other government actions. Some banks and other lenders have suffered significant losses and have become reluctant to lend, even on a secured basis, due to the increased risk of default and the impact of declining asset values on the value of collateral. The foregoing has significantly weakened the strength and the liquidity of some financial institutions worldwide. In 2008, the U.S. government, the Federal Reserve, and other regulators have taken numerous steps to increase liquidity and to restore investor confidence, including investing approximately $200 billion in the equity of other banking organizations. In spite of this, asset values have continued to decline, and access to liquidity continues to be very limited.

The Company s financial performance generally is highly dependent upon the business environment in the suburban metropolitan Chicago market and the United States as a whole. In particular, this environment impacts the ability of borrowers to pay interest on and repay principal of outstanding loans and the value of collateral securing those loans. A favorable business environment is generally characterized by economic growth, efficient capital markets, low inflation, high business and investor confidence, strong business earnings, and other factors. Unfavorable or uncertain economic and market conditions can be caused by declines in economic growth, business activity, or investor or business confidence; limitations on the availability or increases in the cost of credit and capital; increases in inflation or interest rates; natural disasters; or a combination of these or other factors.

Overall, during 2008, the business environment has been adverse for many households and businesses in the United States and worldwide. The business environment in the markets in which the Company operates has been adversely affected and continues to deteriorate. It is expected that the business environment in the suburban Chicago metropolitan market, the United States, and worldwide will continue to deteriorate for the foreseeable future. There can be no assurance that these conditions will improve in the near term. Such conditions could have a material adverse effect on the credit quality of the Company s loans, and therefore, its financial condition and results of operations.

The Company Is Subject To Interest Rate Risk

The Company s earnings and cash flows are largely dependent upon its net interest income. Net interest income is the difference between interest income earned on interest-earning assets such as loans and securities and interest expense paid on interest-bearing liabilities such as deposits and borrowed funds. Interest rates are highly sensitive to many factors that are beyond the Company s control, including general economic conditions and policies of various governmental and regulatory agencies, in particular, the Board of Governors of the Federal Reserve System. Changes in monetary policy, including changes in interest rates, could influence the amount of interest the Company receives on loans and securities and the amount of interest it pays on deposits and borrowings. Such changes could also affect (i) the Company s ability to originate loans and obtain deposits, (ii) the fair value of the Company s financial assets and liabilities, and (iii) the average duration of the Company s securities portfolio. If the interest rates paid on deposits and other borrowings increase at a faster rate than the interest rates received on loans and other investments, the Company s net interest income, and therefore earnings, could be adversely affected. Earnings could also be adversely affected if the interest rates received on loans and other investments fall more quickly than the interest rates paid on deposits and other borrowings.

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Although management believes it has implemented effective asset and liability management strategies to reduce the potential effects of changes in interest rates on the Company s results of operations, any substantial, unexpected, prolonged change in market interest rates could have a material adverse effect on the Company s financial condition and results of operations. See the section captioned Net Interest Income in Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations, located elsewhere in this report for further discussion related to the Company s management of interest rate risk.

The Company Is Subject To Lending Risk

There are inherent risks associated with the Company s lending activities. These risks include the impact of changes in interest rates and changes in the economic conditions in the markets where the Company operates as well as those across the United States. Increases in interest rates and/or continuing weakening economic conditions could adversely impact the ability of borrowers to repay outstanding loans or the value of the collateral securing those loans. Continuing economic weakness on real estate and related markets could further increase the Company s lending risk as it relates to its commercial real estate loan portfolio and the value of the underlying collateral. The Company is also subject to various laws and regulations that affect its lending activities. Failure to comply with applicable laws and regulations could subject the Company to regulatory enforcement action that could result in the assessment of significant civil monetary penalties against the Company.

As of December 31, 2008, 86.1% of the Company s loan portfolio consisted of commercial and industrial and commercial real estate loans. These types of loans are generally viewed as having more risk of default than consumer loans. These types of loans are also typically larger. Because the Company s loan portfolio contains a significant number of commercial and industrial and commercial real estate loans with relatively large balances, the deterioration of one or a few of these loans could cause a significant increase in non-performing loans. An increase in non-performing loans could result in a net loss of earnings from these loans, an increase in the provision for loan losses, and an increase in loan charge-offs, all of which could have a material adverse effect on the Company s financial condition and results of operations. See the section captioned Loans in Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations, located elsewhere in this report for further discussion related to commercial and industrial and commercial real estate loans.

The Company s Reserve For Loan Losses May Be Insufficient

The Company maintains a reserve for loan losses, which is a reserve established through a provision for probable loan losses charged to expense, that represents management s best estimate of probable losses that have been incurred within the existing portfolio of loans. The reserve, in the judgment of management, is necessary to reserve for estimated loan losses and risks inherent in the loan portfolio. The level of the reserve reflects management s continuing evaluation of industry concentrations; specific credit risks; loan loss experience; current loan portfolio quality; present economic, political, and regulatory conditions; and unidentified losses inherent in the current loan portfolio. The determination of the appropriate level of the reserve for loan losses inherently involves a high degree of subjectivity and requires the Company to make estimates of significant credit risks and future trends, all of which may undergo material changes. Continuing deterioration in economic conditions affecting borrowers, new information regarding existing loans, identification of additional problem loans, and other factors, both within and outside of the Company s control, may require an increase in the reserve for loan losses. In addition, bank regulatory agencies periodically review the Company s reserve for loan losses and may require an increase in the provision for loan losses or the recognition of further loan charge-offs, based on judgments different from those of management. In addition, if charge-offs in future periods exceed the reserve for loan losses, the Company will need additional provisions to increase the reserve for loan losses. Any increases in the reserve for loan losses will result in a decrease in net income and capital and may have a material adverse effect on the Company s financial condition and results of operations. See the section captioned Reserve for Loan Losses in Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations, located elsewhere in this report for further discussion related to the Company s process for determining the appropriate level of the reserve for loan losses.

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The Company s Estimate of Fair Values for Its Investments May Not Be Realizable If It Were to Sell These Securities Today

As of December 31, 2008, 99.9% of the Company s investment securities were carried at fair value. Accounting standards required the Company to categorize these according to fair value valuation hierarchy. Ninety-seven percent of these were categorized in level 2 of the valuation hierarchy (meaning that their fair value was determined by quoted prices for similar assets or other observable inputs). The remaining were categorized as level 3 (meaning that their fair value was determined by inputs that are unobservable in the market and therefore require a greater degree of management judgment). The determination of fair value for securities categorized in level 3 involves significant judgment due to the complexity of factors contributing to the valuation, many of which are not readily observable in the market. The current market disruptions make valuation even more difficult and subjective.

The Company has historically placed a high level of reliance on information obtained from third-party sources to measure fair values. For certain of its securities, the Company uses a structured credit valuation firm to perform cash flow projections using various historical and market inputs. For other securities, third-party sources also use assumptions, judgments, and estimates in determining securities values, and different third parties use different methodologies or provide different prices for similar securities. In addition, the nature of the business of the third party source that is valuing the securities at any given time could impact the valuation of the securities. Consequently, the ultimate sales price for any of these securities could vary significantly from the recorded fair value at December 31, 2008, especially if the security is sold during a period of illiquidity or market disruption or as part of a large block of securities under a forced transaction.

Turmoil in the Financial Markets Could Result in Lower Fair Values for the Company s Investment Securities

Major disruptions in the capital markets experienced in the past year have adversely affected investor demand for all classes of securities and resulted in volatility in the fair values of the Company s investment securities. Significant prolonged reduced investor demand could manifest itself in lower fair values for these securities and may result in recognition of an other-than-temporary impairment. Such impairment could have a material adverse effect on the Company s financial condition and results of operations.

The Company Is Subject To Environmental Liability Risk Associated With Lending Activities

A significant portion of the Company s loan portfolio is secured by real property. During the ordinary course of business, the Company may foreclose on and take title to properties securing certain loans. In doing so, there is a risk that hazardous or toxic substances could be found on these properties. If hazardous or toxic substances are found, the Company may be liable for remediation costs, as well as for personal injury and property damage. Environmental laws may require the Company to incur substantial expenses and could materially reduce the affected property s value or limit the Company s ability to use or sell the affected property. In addition, future laws or more stringent interpretations or enforcement policies with respect to existing laws may increase the Company s exposure to environmental liability. Although the Company has policies and procedures to perform an environmental review before initiating any foreclosure action on real property, these reviews may not be sufficient to detect all potential environmental hazards. The remediation costs and any other financial liabilities associated with an environmental hazard could have a material adverse effect on the Company s financial condition and results of operations.

The Company s Profitability Depends Significantly On Economic Conditions in the Suburban Metropolitan Chicago Market

Unlike larger national or other regional banks that are more geographically diversified, the Company s success depends to a large degree on the general economic conditions of the suburban Chicago metropolitan area and, to a lesser extent, other central and western markets in Illinois and contiguous states. The economic conditions in these areas have a significant impact on the demand for the Company s products and services, the ability of the Company s customers to repay loans, the value of the collateral securing loans, and the stability of the Company s deposit funding sources. Although the suburban metropolitan Chicago economy is diversified, it has experienced a decline and is expected to continue to decline for some period. A significant decline in general economic conditions, whether caused by recession, inflation, unemployment, changes in securities markets, acts of terrorism, outbreak of hostilities or other international or domestic occurrences, or other factors could impact these local economic conditions and, in turn, have a material adverse effect on the Company s financial condition and results of operations.

The Company s Investment in Bank Owned Life Insurance May Decline in Value

The Company currently has bank owned life insurance contracts with a cash surrender value (CSV) of $198.5 million. A majority of these contracts are separate account contracts. Such contracts are supported by underlying investments whose fair values are subject to volatility in the market. The Company has limited its risk of loss in value of the securities by putting in place stable value contracts that provide protection from a decline in fair value down to 80% of the CSV of the insurance policies. To the extent fair values on individual contracts fall below 80%, the CSV of specific contracts may be reduced or the underlying assets transferred to short-duration investments, resulting in lower earnings. Given the decline in the market during 2008, the Company transferred certain assets underlying specific separate contracts to money market accounts. Currently, the fair value for all contracts exceeds 80%, but continued turmoil in the market could result in declines that could have a material adverse effect on the Company s financial condition and results of operations.

The Company May Be Adversely Affected By the Soundness Of Other Financial Institutions

Financial services institutions are interrelated as a result of trading, clearing, counterparty, or other relationships. The Company has exposure to many different industries and counterparties and routinely executes transactions with counterparties in the financial services industry, including commercial banks, brokers and dealers, investment banks, and other institutional clients. Many of these transactions expose the Company to credit risk in the event of a default by a counterparty or client. In addition, the Company s credit risk may be exacerbated when the collateral held by the Company cannot be realized upon liquidation or is liquidated at prices not sufficient to recover the full amount of the credit or derivative exposure due the Company. Any such losses could have a material adverse effect on the Company s financial condition and results of operations.

The Company Operates In A Highly Competitive Industry and Market Area

The Company faces substantial competition in all areas of its operations from a variety of different competitors, many of which are larger and may have more financial resources. Such competitors primarily include national, regional, and community banks within the markets where the Company operates. The Company also faces competition from many other types of financial institutions, including, without limitation, savings and loans, credit unions, finance companies, brokerage firms, insurance companies, factoring companies, and other financial intermediaries. The financial services industry could become even more competitive as a result of legislative, regulatory and technological changes, further illiquidity in the credit markets, and continued consolidation. Banks, securities firms, and insurance companies can merge under the umbrella of a financial holding company, which can offer virtually any type of financial service, including banking, securities underwriting, insurance, and merchant banking. Also, technology has lowered barriers to entry and made it possible for non-banks to offer products and services traditionally provided by banks, such as automatic funds transfer and automatic payment systems. Many of the Company s competitors have fewer regulatory constraints and may have lower cost structures. Additionally, due to their size, many competitors may be able to achieve economies of scale and, as a result, may offer a broader range of products and services as well as better pricing for those products and services than the Company can.

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The Company s ability to compete successfully depends on a number of factors, including:

- Developing, maintaining, and building long-term customer relationships;
- Expanding the Company s market position;
- Offering products and services at prices and with the features that meet customers needs and demands;
- Introducing new products and services;
- Maintaining a satisfactory level of customer service;
- Anticipating and adjusting to changes in industry and general economic trends.

Failure to perform in any of these areas could significantly weaken the Company s competitive position, which could adversely affect the Company s growth and profitability. This, in turn, could have a material adverse effect on the Company s financial condition and results of operations.

New Lines of Business or New Products and Services May Subject the Company to Additional Risks

From time to time, the Company may implement new lines of business or offer new products or services within existing lines of business. There can be substantial risks and uncertainties associated with these efforts, particularly in instances where the markets are not fully developed. In developing and marketing new lines of business and/or new products or services, the Company may invest significant time and resources. Initial timetables for the introduction and development of new lines of business and/or new products or services may not be achieved, and price and profitability targets may not prove feasible. External factors, such as compliance with regulations, competitive alternatives, and shifting market preferences, may also impact the successful implementation of a new line of business or a new product or service. Furthermore, any new line of business and/or new product or service could have a significant impact on the effectiveness of the Company s system of internal controls. Failure to successfully manage these risks in the development and implementation of new lines of business or new products or services could have a material adverse effect on the Company s business, financial condition, and results of operations.

The Company Is Subject To Extensive Government Regulation and Supervision

The Company and the Bank are subject to extensive federal and state regulations and supervision. Banking regulations are primarily intended to protect depositors funds, FDIC funds, and the banking system as a whole, not security holders. These regulations affect the Company s lending practices, capital structure, investment practices, dividend policy, and growth, among other things. Congress and federal regulatory agencies continually review banking laws, regulations, and policies for possible changes. It is likely that there will be significant changes to the banking and financial institutions regulatory regimes in the near future in light of the recent performance of and government intervention in the financial services sector. Changes to statutes, regulations, or regulatory policies, including changes in the interpretation or implementation of those policies, could affect the Company in substantial and unpredictable ways. Such changes could subject the Company to additional costs, limit the types of financial services and products the Company may offer, and/or increase the ability of non-banks to offer competing financial services and products, among other things. Failure to comply with laws, regulations, or policies could result in sanctions by regulatory agencies, civil monetary penalties, and/or damage to the Company s reputation, which could have a material adverse effect on the Company s business, financial condition, and results of operations. While the Company has policies and procedures designed to prevent any such violations, there can be no assurance that such violations will not occur. See the section captioned Supervision and Regulation in Item 1, Business, and Note 19 of Notes to Consolidated Financial Statements included in Item 8, Financial Statements and Supplementary Data, which are located elsewhere in this report.

Recent Legislative and Regulatory Actions Taken to Stabilize the U.S. Banking System and Additional Actions Being Considered May Not Succeed Or May Disadvantage the Company

In response to the recent financial market crisis, the United States government, specifically the Treasury, Federal Reserve, and FDIC, working in cooperation with foreign governments and other central banks, has taken a variety of extraordinary measures designed to restore confidence in the financial markets and to strengthen financial institutions, including measures available under the EESA. The EESA followed, and has been followed by, numerous actions by the Federal Reserve, U.S. Congress, Treasury, FDIC, SEC, and others to address the current liquidity and credit crisis that has followed the sub-prime meltdown that commenced in 2007. These measures include homeowner relief that encourages loan restructuring and modification; the establishment of significant liquidity and credit facilities for financial institutions and investment banks; the lowering of the federal funds rate; emergency action against short selling practices; a temporary guaranty program for money market funds; the establishment of a commercial paper funding facility to provide back-stop liquidity to commercial paper issuers; and coordinated international efforts to address illiquidity and other weaknesses in the banking sector. The purpose of these legislative and regulatory actions is to stabilize the U.S. banking system. However, there can be no assurance as to the actual impact the EESA will have on the financial markets, including the extreme levels of volatility and limited credit availability currently being experienced by some institutions, and they may not have their desired effects. If the volatility in the markets continues and economic conditions fail to improve or worsen, the Company s business, financial condition, and results of operations could be materially and adversely affected.

The Treasury is currently developing additional programs to further alleviate the ongoing financial crisis. There can be no assurance that the Company will be able to participate in future programs. If the Company is unable to participate, it may have a material adverse effect on the Company s financial condition and results of operations.

The Company s Information Systems May Experience an Interruption or Breach in Security

The Company relies heavily on communications and information systems to conduct its business. Any failure, interruption, or breach in security of these systems could result in failures or disruptions in the Company s customer relationship management, general ledger, deposit, loan, or other systems. The Company has policies and procedures expressly designed to prevent or limit the effect of a failure, interruption, or security breach of its systems. However, there can be no assurance that any such failures, interruptions, or security breaches will not occur or, if they do occur, that the impact will not be substantial. The occurrence of any failures, interruptions, or security breaches of the Company s systems could damage the Company s reputation, result in a loss of customer business, subject the Company to additional regulatory scrutiny, or expose the Company to civil litigation and possible financial liability, any of which could have a material adverse effect on the Company s financial condition and results of operations.

The Company Is Dependent Upon Outside Third Parties for Processing and Handling of Company Records and Data

The Company relies on software developed by third party vendors to process various Company transactions. In some cases, the Company has contracted with third parties to run its proprietary software on behalf of the Company. These systems include, but are not limited to, general ledger, payroll, employee benefits, trust record keeping, loan processing, merchant processing, and securities portfolio management. While the Company performs a review of controls instituted by the vendor over these programs in accordance with industry standards and performs its own testing of user controls, the Company must rely on the continued maintenance of these controls by the outside party, including safeguards over the security of customer data. In addition, the Company maintains backups of key processing output daily in the event of a failure on the part of any of these systems. Nonetheless, the Company may incur a temporary disruption in its ability to conduct its business or process its transactions, or incur damage to its reputation if the third party vendor fails to adequately maintain internal controls or institute necessary changes to systems. Such disruption or breach of security may have a material adverse effect on the Company s financial condition and results of operations.

The Company Continually Encounters Technological Change

The banking and financial services industry continually undergoes technological changes, with frequent introductions of new technology-driven products and services. In addition to serving customers better, the effective use of technology increases efficiency and enables financial institutions to reduce costs. The Company s future success will depend, in part, on its ability to address the needs of its customers by using technology to provide products and services that enhance customer convenience and that create additional efficiencies in the Company s operations. Many of the Company s competitors have greater resources to invest in technological improvements, and the Company may not effectively implement new technology-driven products and services or do so as quickly, which could reduce its ability to effectively compete. Failure to successfully keep pace with technological change affecting the financial services industry could have a material adverse effect on the Company s business and, in turn, its financial condition and results of operations.

The Company Is Subject to Claims and Litigation Pertaining to Fiduciary Responsibility

From time to time, customers make claims and take legal action pertaining to the Company s performance of its fiduciary responsibilities. Whether customer claims and legal action related to the Company s performance of its fiduciary responsibilities are founded or unfounded, if such claims and legal action are not resolved in a manner favorable to the Company, they may result in significant financial liability and/or adversely affect the market perception of the Company and its products and services as well as impact customer demand for those products and services. Any financial liability or reputational damage could have a material adverse effect on the Company s business, which, in turn, could have a material adverse effect on its financial condition and results of operations.

Consumers and Businesses May Decide Not to Use Banks to Complete Their Financial Transactions

Technology and other changes are allowing parties to complete financial transactions that historically have involved banks at one or both ends of the transaction. For example, consumers can now pay bills and transfer funds directly without banks. This could result in the loss of fee income as well as the loss of customer deposits and income generated from those deposits and could have a material adverse effect on the Company s financial condition and results of operations.

The Company s Controls and Procedures May Fail or Be Circumvented

Management regularly reviews and updates the Company s internal controls, disclosure controls and procedures, and corporate governance policies and procedures. Any system of controls, however well designed and operated, is based in part on certain assumptions and can provide only reasonable, not absolute, assurances that the objectives of the system are met. Any failure or circumvention of the Company s controls and procedures or failure to comply with regulations related to controls and procedures could have a material adverse effect on the Company s business, financial condition, and results of operations.

Financial Services Companies Depend Upon the Accuracy and Completeness of Information About Customers and Counterparties

In deciding whether to extend credit or enter into other transactions, the Company may rely on information furnished by or on behalf of customers and counterparties, including financial statements, credit reports and other financial information. The Company may also rely on representations of those customers, counterparties or other third parties, such as independent auditors, as to the accuracy and completeness of that information. Reliance on inaccurate or misleading financial statements, credit reports or other financial information could have a material adverse effect on the Company s business and, in turn, the Company s financial condition and results of operations.

The Company and Its Subsidiaries Are Subject to Examinations and Challenges by Taxing Authorities

In the normal course of business, the Company and its subsidiaries are routinely subjected to examinations and challenges from federal and state taxing authorities regarding the amount of taxes due in connection with

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investments made and the businesses in which it has engaged. Federal and state taxing authorities have recently become increasingly aggressive in challenging tax positions taken by financial institutions, including positions that have been taken by the Company. These tax positions may relate to tax compliance, sales and use, franchise, gross receipts, payroll, property, or income tax issues, including tax base, apportionment, and tax planning. The challenges made by taxing authorities may result in adjustments to the timing or amount of taxable income or deductions or the allocation of income among tax jurisdictions. If any such challenges are not resolved in the Company s favor, they could have a material adverse effect on the Company s financial condition and results of operations.

The Company and Its Subsidiaries Are Subject to Changes in Federal and State Tax Laws and Changes in Interpretation of Existing Laws

The Company s financial performance is impacted by federal and state tax laws. Given the current economic environment, new presidential administration, and ongoing state budgetary pressures, the enactment of new federal or state tax legislation may occur. The enactment of such legislation, or changes in the interpretation of existing law, including provisions impacting tax rates, apportionment, consolidation or combination, income, expenses, and credits, may have a material adverse effect on the Company s financial condition and results of operations.

The Company and Its Subsidiaries Are Subject to Changes in Accounting Principles, Policies, or Guidelines

The Company s financial performance is impacted by accounting principles, policies, and guidelines. Changes in these are continuously occurring, and given the current economic environment, more drastic changes may occur. The implementation of such changes could have a material adverse effect on the Company s financial condition and results of operations.

The Company May Not Be Able to Attract and Retain Skilled People

The Company s success depends, in large part, on its ability to attract and retain key people. Competition for the best people in most activities the Company engages in can be intense, and the Company may not be able to hire people or retain them.

Participation in the CPP could also affect the Company s ability to attract and retain key people. Due to the Company s participation in the CPP, the Company is subject to executive compensation limitations, which may not apply to other financial institutions.

The unexpected loss of services of one or more of the Company s key personnel could have a material adverse impact on the Company s business because of their skills, knowledge of the Company s market, years of industry experience, and the difficulty of promptly finding qualified replacement personnel.

The Company Is a Bank Holding Company and Its Sources of Funds Are Limited

The Company is a bank holding company, and its operations are primarily conducted by the Bank, which is subject to significant federal and state regulation. Cash available to pay dividends to stockholders of the Company is derived primarily from dividends received from the Bank. The Company s ability to receive dividends or loans from its subsidiaries is restricted. Dividend payments by the Bank to the Company in the future will require generation of future earnings by the Bank and could require regulatory approval if the proposed dividend is in excess of prescribed guidelines. Further, the Company s right to participate in the assets of the Bank upon its liquidation, reorganization, or otherwise will be subject to the claims of the Bank s creditors, including depositors, which will take priority except to the extent the Company may be a creditor with a recognized claim. As of December 31, 2008, the Company s subsidiaries had deposits and other liabilities of $7.6 billion.

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The Company Could Experience an Unexpected Inability to Obtain Needed Liquidity

Liquidity measures the ability to meet current and future cash flow needs as they become due. The liquidity of a financial institution reflects its ability to meet loan requests, to accommodate possible outflows in deposits, and to take advantage of interest rate market opportunities. The ability of a financial institution to meet its current financial obligations is a function of its balance sheet structure, its ability to liquidate assets, and its access to alternative sources of funds. The Company seeks to ensure its funding needs are met by maintaining a level of liquidity through asset/liability management. If the Company becomes unable to obtain funds when needed, it could have a material adverse effect on the Company s business and, in turn, the Company s financial condition and results of operations.

Severe Weather, Natural Disasters, Acts of War or Terrorism and Other External Events Could Significantly Impact the Company s Business

Severe weather, natural disasters, acts of war or terrorism and other adverse external events could have a significant impact on the Company s ability to conduct business. Such events could affect the stability of the Company s deposit base, impair the ability of borrowers to repay outstanding loans, reduce the value of collateral securing loans, cause significant property damage, result in loss of revenue and/or cause the Company to incur additional expenses. Although management has established disaster recovery policies and procedures, the occurrence of any such event could have a material adverse effect on the Company s business, which, in turn, could have a material adverse effect on its financial condition and results of operations.

Future Acquisitions May Disrupt the Company s Business and Dilute Stockholder Value

In addition to generating internal growth, in the past the Company has strategically acquired banks or branches of other banks. The Company may consider future acquisitions to supplement internal growth opportunities. Acquiring other banks or branches involves potential risks, including:

- Exposure to unknown or contingent liabilities of acquired banks;
- Exposure to asset quality issues of acquired banks;
- Disruption of the Company s business;
- Loss of key employees and customers of acquired banks;
- Short-term decrease in profitability;
- Diversion of management s time and attention;
- Issues arising during transition and integration; and
- Dilution in the ownership percentage of holdings of the Company s common stock.

The Company from time to time may evaluate merger and acquisition opportunities and conduct due diligence activities related to possible transactions with other financial institutions and financial services companies. As a result, merger or acquisition discussions and, in some cases, negotiations may take place and future mergers or acquisitions involving cash, debt or equity securities may occur at any time. Acquisitions typically involve the payment of a premium over book and market values, and therefore, some dilution of the Company s tangible book value and net income per common share may occur in connection with any future transaction. Furthermore, failure to realize the expected revenue increases, cost savings, increases in geographic or product presence, and/or other projected benefits from an acquisition could have a material adverse effect on the Company s financial condition and results of operations.

Competition for Acquisition Candidates Is Intense

Competition for acquisitions is intense. Numerous potential acquirors compete with the Company for acquisition candidates. The Company may not be able to successfully identify and acquire suitable targets, which could slow the Company s growth rate.

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Decline In the Company s Stock Price Below Tangible Book Value Could Require a Write-down of Some Portion or All of the Company s Goodwill

If the Company s stock price declines and remains below its tangible book value for an extended period of time, the Company could be required to write off all or a portion of its goodwill, which represents the value in excess of the Company s tangible book value. Such write off would reduce earnings in the period in which it is recorded. The Company s stock price is subject to market conditions that can be impacted by forces outside of the control of management, such as a perceived weakness in financial institutions in general, and may not be a direct result of the Company s performance. A write-down of goodwill could have a material adverse effect on the Company s results of operations.

Future Growth or Operating Results May Require the Company to Raise Additional Capital But that Capital May Not Be Available or It May Be Dilutive

The Company is required by federal and state regulatory authorities to maintain adequate levels of capital to support its operations. To the extent the Company s future operating results erode capital or the Company elects to expand through loan growth or acquisition it may be required to raise capital.

The Company s ability to raise capital will depend on conditions in the capital markets, which are outside of its control, and on the Company s financial performance. Accordingly, the Company cannot be assured of its ability to raise capital when needed or on favorable terms. If the Company cannot raise additional capital when needed, it will be subject to increased regulatory supervision and the imposition of restrictions on its growth and business. These could negatively impact the Company s ability to operate or further expand its operations through acquisitions or the establishment of additional branches and may result in increases in operating expenses and reductions in revenues that could have a material adverse effect on its financial condition and results of operations.

Any Reduction in the Company s Credit Ratings Could Increase Its Financing Costs

Various rating agencies publish credit ratings for the Company s debt obligations, based on their evaluations of a number of factors, some of which relate to Company performance and some which relate to general industry conditions. Management routinely communicates with each rating agency and anticipates the rating agencies will closely monitor the Company s performance and update their ratings from time to time during the year.

The Company cannot give any assurance that its current credit ratings will remain in effect for any given period of time or that a rating will not be lowered or withdrawn entirely by a rating agency if, in its judgment, circumstances in the future so warrant. Downgrades in the Company s credit ratings may adversely affect its borrowing costs and its ability to borrow or raise capital, and may adversely affect the Company s reputation. The Company currently is rated BBB+ by Standard & Poor s Ratings Group, a division of The McGraw-Hill Companies, Inc., A3 by Moody s Investors Service, Inc., and BBB+ by Fitch, Inc.

Risks Associated With the Company s Common Stock

The Company s Stock Price Can Be Volatile

Stock price volatility may make it more difficult for you to resell your common stock when you want and at prices you find attractive. The Company s stock price can fluctuate significantly in response to a variety of factors including:

Actual or anticipated variations in quarterly results of operations;
Recommendations by securities analysts;
Operating and stock price performance of other companies that investors deem comparable to the Company;

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- News reports relating to trends, concerns, and other issues in the financial services industry;
- Perceptions in the marketplace regarding the Company and/or its competitors;
- New technology used or services offered by competitors;
- Significant acquisitions or business combinations, strategic partnerships, joint venture, or capital commitments by or involving the Company or its competitors;
- Failure to integrate acquisitions or realize anticipated benefits from acquisitions;
- Changes in government regulations;
- Geopolitical conditions such as acts or threats of terrorism or military conflicts.

General market fluctuations, industry factors, and general economic and political conditions and events, such as economic slowdowns or recessions, interest rate changes, or credit loss trends, could also cause the Company s stock price to decrease regardless of operating results.

The Trading Volume In the Company s Common Stock Is Less Than That Of Other Larger Financial Services Institutions

Although the Company s common stock is listed for trading on the Nasdaq Stock Market Exchange, the trading volume in its common stock is less than that of other, larger financial services companies. A public trading market having the desired characteristics of depth, liquidity, and orderliness depends on the presence in the marketplace of willing buyers and sellers of the Company s common stock at any given time. This presence depends on the individual decisions of investors and general economic and market conditions over which the Company has no control. Given the lower trading volume of the Company s common stock, significant sales of the Company s common stock, or the expectation of these sales could cause the Company s common stock price to fall.

An Investment In the Company s Common Stock Is Not An Insured Deposit

The Company s common stock is not a bank deposit and, therefore, is not insured against loss by the FDIC, any other deposit insurance fund, or by any other public or private entity. Investment in the Company s common stock is inherently risky for the reasons described in this Risk Factors section and elsewhere in this report and is subject to the same market forces that affect the price of common stock in any company. As a result, if you acquire the Company s common stock, you could lose some or all of your investment.

The Company s Restated Certificate of Incorporation, Amended and Restated By-Laws, and Amended and Restated Rights Agreement As Well As Certain Banking Laws May Have An Anti-Takeover Effect

Provisions of the Company s Restated Certificate of Incorporation and Amended and Restated By-laws, federal banking laws, including regulatory approval requirements, and the Company s Amended and Restated Rights Plan could make it more difficult for a third party to acquire the Company, even if doing so would be perceived to be beneficial by the Company s stockholders. The combination of these provisions effectively inhibits a non-negotiated merger or other business combination, which, in turn, could adversely affect the market price of the Company s common stock.

The Company May Issue Additional Securities, Which Could Dilute the Ownership Percentage of Holders of the Company s Common Stock

The Company may issue additional securities to raise additional capital or finance acquisitions or upon the exercise or conversion of outstanding options, and, if it does, the ownership percentage of holders of the Company s common stock could be diluted.

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The Company s Participation in the CPP May Adversely Affect the Value of its Common Stock and the Rights of its Common Stockholders

The rights of the holders of the Company s common stock may be adversely affected by the Company s participation in the CPP. For example:

- Prior to the earlier of December 5, 2011 and the date on which all of the Preferred Shares have been redeemed by the Company or transferred by Treasury to third parties, the Company may not, without the consent of Treasury, subject to limited exceptions, redeem, repurchase, or otherwise acquire shares of the Company s common stock or preferred stock.
- The Company may not pay dividends on its common stock unless it has fully paid all required dividends on the Preferred Shares. Although the Company fully expects to be able to pay all required dividends on the Preferred Shares, there is no guarantee that it will be able to do so.
- As long as the Treasury owns the securities purchased from the Company under the CPP, the Company may not, without the prior consent of the Treasury, increase the quarterly dividends it pays on its common stock above $0.31 per share.
- The Preferred Shares will receive preferential treatment in the event of liquidation, dissolution, or winding up of the Company.
- The ownership interest of the existing holders of the Company s common stock will be diluted to the extent the warrant the Company issued to Treasury in conjunction with the sale to Treasury of the Preferred Shares is exercised.

In addition, terms of the Preferred Shares require that quarterly dividends be paid on the Preferred Shares at the rate of 5% per annum for the first five years and 9% per annum thereafter until the stock is redeemed by First Midwest. The payments of these dividends will decrease the excess cash the Company otherwise has available to pay dividends on its common stock and to use for general corporate purposes, including working capital.

The Company has not established a minimum dividend payment level, and it cannot assure you of its ability to pay dividends in future.

The Company has not established a minimum dividend payment level, and the amount of its dividend may fluctuate. All dividends will be made at the discretion of the Company s Board of Directors and will depend upon the Company s earnings, financial condition, and such other factors as the Board of Directors may deem relevant from time to time. The Company s Board of Directors may change its dividend policy in the future.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

ITEM 2. PROPERTIES

The executive offices of the Company, the Bank, and certain subsidiary operational facilities are located in a 16-story office building in Itasca, Illinois. The Company and the Bank currently occupy 60,933 square feet of that building, which is leased from an unaffiliated third party.

As of December 31, 2008, the Bank operated through 97 bank branches, one operational facility, and one dedicated lending office. Of these, 25 are leased and the remaining 74 are owned and not subject to any material liens. The banking offices are largely located in various communities throughout northern Illinois and northwestern Indiana, primarily the Chicago metropolitan suburban area. At certain Bank locations, excess space is leased to third parties. The Bank also owns 129 automated teller machines (ATMs), some of which are housed at banking locations and some of which are independently located. In addition, the Company owns other real property that, when considered individually or in the aggregate, is not material to the Company s financial position.

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The Company believes its facilities in the aggregate are suitable and adequate to operate its banking business. Additional information with respect to premises and equipment is presented in Note 6 of Notes to Consolidated Financial Statements in Item 8 of this Form 10-K.

ITEM 3. LEGAL PROCEEDINGS

There are certain legal proceedings pending against the Company and its subsidiaries in the ordinary course of business at December 31, 2008. Based on presently available information, the Company believes that any liabilities arising from these proceedings would not have a material adverse effect on the consolidated financial condition of the Company.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

There were no items submitted to a vote of stockholders during the fourth quarter of 2008.

PART II

ITEM 5. MARKET FOR THE REGISTRANT S COMMON EQUITY, RELATED STOCKHOLDER MATTERS, AND ISSUER PURCHASES OF EQUITY SECURITIES

The Company s common stock is traded under the symbol FMBI in the Nasdaq Global Select market tier of The Nasdaq Stock Market. As of December 31, 2008, there were approximately 11,500 stockholders. The following table sets forth the closing common stock price, dividends declared per share, and book value per share during each quarter of 2008 and 2007.

	2008				2007			
	Fourth	Third	Second	First	Fourth	Third	Second	First
Market price of common stock								
High	$ 28.97	$ 40.09	$ 29.36	$ 31.98	$ 36.50	$ 36.62	$ 38.17	$ 39.31
Low	$ 13.65	$ 13.56	$ 18.65	$ 24.38	$ 29.67	$ 31.87	$ 34.82	$ 36.00
Quarter-end	$ 19.97	$ 24.24	$ 18.65	$ 27.77	$ 30.60	$ 34.16	$ 35.51	$ 36.75
Cash dividends declared per share	$ 0.225	$ 0.310	$ 0.310	$ 0.310	$ 0.310	$ 0.295	$ 0.295	$ 0.295
Dividend yield at quarter-end [(1)]	4.51%	5.12%	6.65%	4.47%	4.05%	3.45%	3.32%	3.21%
Book value per common share at quarter-end	$ 14.72	$ 14.80	$ 14.90	$ 15.20	$ 14.94	$ 14.94	$ 14.97	$ 15.16

(1) Ratios are presented on an annualized basis.

A discussion regarding the regulatory restrictions applicable to the Bank s ability to pay dividends to the Company is included in the Supervision and Regulation - Dividends section under Item 1 of this Form 10-K. A discussion of the Company s philosophy regarding the payment of dividends is included in the Management of Capital section of Management s Discussion and Analysis of Financial Condition and Results of Operations in Item 7 of this Form 10-K.

Equity Compensation Plans

The following table sets forth information, as of December 31, 2008, relating to equity compensation plans of the Company pursuant to which options, restricted stock, restricted stock units, or other rights to acquire shares may be granted from time to time.

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Equity Compensation Plan Category	Number of securities to be issued upon exercise of outstanding options, warrants, and rights (a)	Weighted-average exercise price of outstanding options, warrants, and rights (b)	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) (c)
Approved by security holders [1]	2,816,437	$ 31.53	790,212
Not approved by security holders [2]	5,055	17.86	-
Total	2,821,492	$ 31.51	790,212

(1) Includes all outstanding options and awards under the Omnibus Stock and Incentive Plan and the Non-Employee Directors Stock Option Plan (the Plans). Additional information and details about the Plans are also disclosed in Notes 1 and 18 of Notes to Consolidated Financial Statements in Item 8 of this Form 10-K.

(2) Represents shares underlying deferred stock units credited under the Company s Nonqualified Retirement Plan, payable on a one-for-one basis in shares of the Company s common stock.

The Nonqualified Retirement Plan (the Plan) is a defined contribution deferred compensation plan under which participants are credited with deferred compensation equal to contributions and benefits that would have accrued to the participant under the Company s tax-qualified plans, but for limitations under the Internal Revenue Code, and to amounts of salary and annual bonus that the participant has elected to defer. Participant accounts are deemed to be invested in separate investment accounts under the plan, with similar investment alternatives as those available under the Company s tax-qualified savings and profit sharing plan, including an investment account deemed invested in shares of Company common stock. The accounts are adjusted to reflect the investment return related to such deemed investments. Except for the 5,055 shares set forth in the table above, all amounts credited under the Plan are paid in cash.

Stock Performance Graph

The graph below illustrates, over a five-year period, the cumulative total return (defined as stock price appreciation or depreciation and dividends) to stockholders from the common stock against a broad-market total return equity index and a published industry total return equity index. The broad-market total return equity index used in this comparison is the Standard & Poor s 500 Stock Index (the S&P 500), and the published industry total return equity index used in this comparison is the Standard & Poor s SmallCap 600 Banks Index (S&P SmallCap 600 Banks).

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Comparison of Five-Year Cumulative Total Return Among

First Midwest, the S&P 500, and the S&P SmallCap 600 Banks [(1)]

	2003	2004	2005	2006	2007	2008
First Midwest	100.00	114.81	114.15	129.78	106.32	72.90
S&P 500	100.00	110.88	116.33	134.70	142.10	89.53
S&P SmallCap 600 Banks	100.00	123.41	113.90	125.43	86.05	65.04

(1) Assumes $100 invested on December 31, 2003 in First Midwest s Common Stock, the S&P 500, and the S&P SmallCap 600 Banks with the reinvestment of all related dividends.

To the extent this Form 10-K is incorporated by reference into any other filing by the Company under the Securities Act of 1933 or the Securities Exchange Act of 1934, the foregoing *Stock Performance Graph* will not be deemed incorporated, unless specifically provided otherwise in such filing and shall not otherwise be deemed filed under such Acts.

Issuer Purchases of Equity Securities

The following table summarizes purchases made by the Company or on its behalf, or by any affiliated purchaser (as defined in Rule 10b-18(a)(3) under the Securities Exchange Act of 1934), of its common stock during the quarter ended December 31, 2008 pursuant to a repurchase program approved by the Company s Board of Directors on November 27, 2007. Up to 2.5 million shares of the Company s common stock may be repurchased, and the total remaining authorization under the program was 2,494,747 shares as of December 31, 2008. The repurchase program has no set expiration or termination date. Any repurchases are subject to limitations imposed as part of the CPP program under the EESA described elsewhere in this report.

Issuer Purchases of Equity Securities

	Total Number of Shares Purchased [(1)]	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plan or Programs	Maximum Number of Shares that May Yet Be Purchased Under the Plan or Programs
October 1 - October 31, 2008	-	$ -	-	2,494,747
November 1 - November 30, 2008	129	25.13	-	2,494,747
December 1 - December 31, 2008	-	-	-	2,494,747
Total	129	$ 25.13	-	

(1) Consists of shares acquired pursuant to the Company s share-based compensation plans. Under the terms of these plans, the Company accepts shares of common stock from option holders if they elect to surrender previously-owned shares upon exercise to cover the exercise price of the stock options or, in the case of restricted shares of common stock, the withholding of shares to satisfy tax withholding obligations associated with the vesting of restricted shares.

For further details regarding the Company s stock repurchase programs, refer to the section titled Management of Capital in Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations, of this Form 10-K.

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ITEM 6. SELECTED FINANCIAL DATA

Consolidated financial information reflecting a summary of the operating results and financial condition of the Company for each of the five years in the period ended December 31, 2008 is presented in the following table. This summary should be read in conjunction with the consolidated financial statements and accompanying notes included elsewhere in this Form 10-K. A more detailed discussion and analysis of the factors affecting the Company s financial condition and operating results is presented in Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations, of this Form 10-K.

	Years ended December 31,				
	2008	2007	2006	2005	2004
Operating Results (Amounts in thousands)					
Interest income	$ 409,207	$ 476,961	$ 476,409	$ 366,700	$ 315,342
Interest expense	162,610	236,832	224,550	130,850	86,478
Net interest income	246,597	240,129	251,859	235,850	228,864
Noninterest income	89,618	111,054	99,014	77,927	73,812
Write-down of bank-owned life insurance included in noninterest income [1]	10,360	-	-	-	-
Noninterest expense	(194,305)	(199,137)	(192,615)	(165,703)	(163,338)
Pre-tax earnings, excluding provision for loan losses and market-related losses [2]	152,270	152,046	158,258	148,074	139,338
Provision for loan losses	(70,254)	(7,233)	(10,229)	(8,930)	(12,923)
Gains (losses) on securities sales, net	8,903	(746)	4,269	(3,315)	13,622
Securities impairment losses	(44,514)	(50,055)	-	-	(5,400)
Write-down of bank-owned life insurance	(10,360)	-	-	-	-
Losses on early extinguishment of debt	-	-	-	-	(2,653)
Income tax benefit (expense)	13,291	(13,853)	(35,052)	(34,452)	(32,848)
Net income	49,336	80,159	117,246	101,377	99,136
Preferred dividends	(712)	-	-	-	-
Net income applicable to common shares	$ 48,624	$ 80,159	$ 117,246	$ 101,377	$ 99,136
Weighted-average common shares outstanding	48,462	49,295	49,102	45,567	46,469
Weighted-average diluted common shares outstanding	48,565	49,622	49,469	45,893	46,860
Per Share Data					
Basic earnings per common share	$ 1.00	$ 1.63	$ 2.39	$ 2.22	$ 2.13
Diluted earnings per common share	1.00	1.62	2.37	2.21	2.12
Common dividends declared	1.155	1.195	1.120	1.015	0.900
Book value at year end	14.72	14.94	15.01	11.99	11.55
Market price at year end	19.97	30.60	38.68	35.06	36.29
Performance Ratios					
Return on average common equity	6.48%	10.69%	16.87%	18.83%	18.68%
Return on average assets	0.59%	0.99%	1.42%	1.44%	1.45%
Net interest margin - tax-equivalent	3.61%	3.58%	3.67%	3.87%	3.91%
Dividend payout ratio	115.50%	73.77%	47.26%	45.93%	42.45%

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Balance Sheet Highlights (Dollar amounts in thousands)	As of December 31, 2008	2007	2006	2005	2004
Total assets	$ 8,528,341	$ 8,091,518	$ 8,441,526	$ 7,210,151	$ 6,863,381
Loans	5,360,063	4,963,672	5,008,944	4,306,191	4,135,278
Deposits	5,585,754	5,778,861	6,167,216	5,147,832	4,905,378
Subordinated debt	232,409	230,082	228,674	130,092	129,294
Long-term portion of Federal Home Loan Bank advances	736	136,064	14,660	13,519	36,743
Stockholders equity	908,279	723,975	751,014	544,068	532,038
Financial Ratios					
Reserve for loan losses as a percent of loans	1.75%	1.25%	1.25%	1.31%	1.37%
Tier 1 capital to risk-weighted assets	11.60%	9.03%	9.56%	10.72%	10.45%
Total capital to risk-weighted assets	14.36%	11.58%	12.16%	11.76%	11.52%
Tier 1 leverage to average assets	9.41%	7.46%	7.29%	8.16%	8.16%
Tangible common equity to tangible assets	5.23%	5.58%	5.62%	6.30%	6.43%

(1) For a further discussion of this write-down and the Company s investment in bank owned life insurance, see the section titled Investment in Bank Owned Life Insurance in Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations, and Note 1 of Notes to Consolidated Financial Statements in Item 8 of this Form 10-K.

(2) The company s accounting and reporting policies conform to U.S. generally accepted accounting principles (GAAP) and general practice within the banking industry. As a supplement to GAAP, the Company has provided this non-GAAP performance result. The Company believes that this non-GAAP financial measure is useful because it allows investors to assess the Company s operating performance. Although this non-GAAP financial measure is intended to enhance investors understanding of the Company s business and performance, this non-GAAP financial measure should not be considered an alternative to GAAP.

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ITEM 7. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

INTRODUCTION

The following discussion and analysis is intended to address the significant factors affecting our Consolidated Statements of Income for the years 2006 through 2008 and Consolidated Statements of Financial Condition as of December 31, 2007 and 2008. When we use the terms First Midwest, the Company, we, us, and our, we mean First Midwest Bancorp, Inc., a Delaware Corporation, and its consolidated subsidiaries. Wh we use the term the Bank, we are referring to our wholly owned banking subsidiary, First Midwest Bank. The discussion is designed to provide stockholders with a comprehensive review of the operating results and financial condition and should be read in conjunction with the consolidated financial statements, accompanying notes thereto, and other financial information presented in this Form 10-K.

A condensed review of operations for the fourth quarter of 2008 is included herein in the section titled Fourth Quarter 2008 vs. 2007. The review provides an analysis of the quarterly earnings performance for the fourth quarter of 2008 compared to the same period in 2007.

Unless otherwise stated, all earnings per share data included in this section and through the remainder of this discussion are presented on a diluted basis.

PERFORMANCE OVERVIEW

General Overview

Our banking network provides a full range of business and retail banking and trust and advisory services through 97 banking branches, one operational facility, and one dedicated lending office primarily in suburban metropolitan Chicago. The primary sources of our revenue are net interest income and fees from financial services provided to customers. Business volumes tend to be influenced by overall economic factors including market interest rates, business spending, consumer confidence, and competitive conditions within the marketplace.

2008 Compared with 2007

Our net income was $49.3 million for 2008 compared to $80.2 million for 2007 and earnings of $1.00 per diluted common share for 2008, as compared to $1.62 per diluted common share for 2007. Return on average assets was 0.59% for 2008 compared to 0.99% for 2007. Return on average common equity was 6.48% for 2008 compared to 10.69% for 2007.

Performance for 2008 was adversely impacted by higher loan loss provisions and securities-related losses, stemming from continued economic weakness, which were partially offset by the recognition of certain nonrecurring tax benefits. Income before taxes totaled $36.0 million for 2008, as compared to $94.0 million for 2007, with the difference largely due to higher provision for loan losses. Provision for loan losses for 2008 was $70.3 million as contrasted to $7.2 million in 2007, with the increase primarily due to deterioration in the Company s residential land and development portfolio. For a discussion of the Company s loan portfolio and credit quality, see the section titled Loan Portfolio and Credit Quality elsewhere in this report. In addition, we recognized net securities impairment losses of $44.5 million in 2008 compared to $50.1 million in 2007. For a discussion of net securities losses, see the section titled Investment Portfolio Management. Excluding the provision for loan losses and market-related losses, income before taxes for both 2008 and 2007 was $152 million.

Average core transactional deposits for 2008 were $3.6 billion, relatively unchanged from 2007. The Company s ability to fund its lending activity predominantly with core customer deposits provides a long-term competitive advantage given the volatility in the cost and availability of wholesale funds.

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Outstanding loans totaled $5.4 billion as of December 31, 2008, an increase of 8.0% from December 31, 2007, with the increase due primarily to growth in the commercial real estate and commercial and industrial loan categories.

Non-accrual loans at December 31, 2008 were $127.8 million, or 2.38% of total loans, compared to $18.5 million, or 0.37% of total loans, at December 31, 2007, with residential land and development loans accounting for $97.1 million of the total. Loans 90 days past due and still accruing totaled $37.0 million, an increase of $15.9 million from the prior year, and foreclosed real estate totaled $24.4 million, an increase of $18.3 million from the prior year.

In response to the impact of continuing economic weakness on real estate and related markets, we increased our reserve for loan losses to $93.9 million as of December 31, 2008, up $32.1 million from December 31, 2007. The reserve for loan losses represented 1.75% of total loans outstanding at December 31, 2008 compared to 1.25% at December 31, 2007. Provision for losses for 2008 totaled $70.3 million and exceeded net charge-offs by $32.1 million.

Net interest margin for 2008 was 3.61% for 2008 compared to 3.58% for 2007 as the Company was able to more than offset declines in asset yields with reductions in its cost of funds.

Fee-based revenues, which comprise the majority of noninterest income, were $95.1 million for full year 2008, down 3.8% from 2007. Excluding certain services the Company discontinued in late 2007 from both years, fee-based revenues declined 1% from 2007, due primarily to lower trust revenue and lower retail sales of investment products.

Noninterest expense for 2008 declined 2.4% from 2007 due primarily to a reduction in salary and benefit costs. Over the past two years the Company has reduced its staffing by 4.4%, or 83 full-time equivalents.

The Company recognized significant federal and state tax benefits due to favorable court rulings and results of examinations related to prior years. These benefits, coupled with the increase in tax-exempt income as a percent of total income in 2008, resulted in a net tax benefit for 2008 of $13.3 million.

2007 Compared with 2006

Net income for 2007 was $80.2 million, which included a $32.5 million after-tax charge to earnings associated with an impairment of the Company s asset-backed collateralized debt securities portfolio. This compared to net income of $117.2 million for 2006. Our earnings per diluted common share was $1.62 for 2007 compared to $2.37 per diluted common share for 2006. The impairment charge reduced 2007 diluted earnings per share by $0.65. Return on average equity was 10.7% for 2007 and 16.9% for 2006. Return on average assets was 0.99% for 2007 and 1.42% for 2006. For additional discussion regarding the impairment charge, refer to the section titled Investment Portfolio Management.

Our securities portfolio declined $301.5 million in 2007. During the first quarter of 2007, we took advantage of the inverted yield curve to sell certain long-term securities at a gain and used the proceeds to reduce our short-term borrowings. When the capital markets began to charge premiums for access to funding in the third quarter, we again responded by selling securities and used the proceeds to reduce our short-term borrowings.

Our total loans outstanding declined $45.3 million from December 31, 2006 to December 31, 2007. The decline reflects the combined impact of the payoff of loan participations purchased as part of a 2006 bank acquisition, rapid prepayment of multi-family loan portfolios during the first half of 2007, and the continued paydown of our indirect auto loan portfolio.

Total average deposits were $5.9 billion for both 2007 and 2006. Declines in average time deposits were substantially offset by increases in average transaction deposits. Average transaction deposits increased $72.0 million from 2006, primarily due to growth in savings deposits.

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Charge-offs as a percentage of average loans were 0.16% in 2007 compared to 0.21% in 2006. As of December 31, 2007, the reserve for loan losses stood at 1.25% of total loans, unchanged from December 31, 2006 and was 330% of non-performing loans.

Net interest income for 2007 declined $11.7 million from 2006, and net interest margin declined 0.09% from 2006 to 3.58%. This reflected narrowing credit spreads resulting from increased competition, a flat to inverted yield curve for much of 2007, and a short-term mismatch between the repricing of interest-earning assets and our funding sources, as the Federal Reserve lowered its targeted discount rate by 1.0% during the last four months of 2007.

Noninterest income, excluding securities gains and losses, increased 12.2% in 2007 compared to 2006. Fee-based revenues, which comprise the majority of noninterest income, increased 12.0%. While increases occurred in most fee categories, the growth for 2007 was primarily due to increases in service charges on deposit accounts, card-based fees, and trust and investment advisory fees.

Noninterest expense was well controlled as reflected by year-over-year growth of 3.4%. Noninterest expense for 2007 included a severance charge of $621,000 related to certain staff reductions initiated in the fourth quarter and a $299,000 charge related to our share of claims from litigation brought by others against VISA, Inc.

In the third quarter of 2007, the State of Illinois passed tax legislation that, in the short term, provided certain tax benefits that we recognized in the second half of 2007. The benefits increased net income by $2.9 million in 2007.

Management s Outlook

Performance for 2008 reflected strong operating performance offset by increased credit- related costs stemming from prolonged and significant weakness in the economy, particularly in the residential housing markets. Over the course of 2008, we worked to prepare ourselves for the demands of this environment by increasing our loan loss reserves, adding to our capital through the issuance of preferred securities and reducing our dividend, as well as expanding our credit remediation resources and reducing our operating costs.

As we enter 2009, continuing weakness in the economy and the residential housing market is expected to further strain all loan portfolio categories, but particularly those supported by real estate. Response by the federal government in the form of both legislative action and stimulus designed to stabilize the economy have been substantial and unprecedented and continue to evolve.

In such an environment, it our belief that our strong core operating performance, coupled with a solid capital base, leaves us positioned to better navigate the uncertainty of the times, meet the needs of our clients and communities, and benefit from future recovery in the market place. In addition, similar to 2008, our focus will remain on tight control of our operating costs and proactive management of our balance sheet as well as all aspects of our capital plans.

EARNINGS PERFORMANCE

Net Interest Income

Net interest income equals the difference between interest income plus fees earned on interest-earning assets and interest expense incurred on interest-bearing liabilities. The level of interest rates and the volume and mix of interest-earning assets and interest-bearing liabilities impact net interest income. Net interest margin represents net interest income as a percentage of total average interest-earning assets. The accounting policies underlying the recognition of interest income on loans, securities, and other interest-earning assets are presented in Note 1 of Notes to Consolidated Financial Statements in Item 8 of this Form 10-K.

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Our accounting and reporting policies conform to U.S. generally accepted accounting principles (GAAP) and general practice within the banking industry. For purposes of this discussion, both net interest income and net interest margin have been adjusted to a fully tax-equivalent basis to more appropriately compare the returns on certain tax-exempt loans and securities to those on taxable interest-earning assets. Although we believe that these non-GAAP financial measures enhance investors understanding of our business and performance, these non-GAAP financial measures should not be considered an alternative to GAAP. The effect of such adjustment is presented in the following table.

Table 1

Effect of Tax-Equivalent Adjustment

(Dollar amounts in thousands)

	Years Ended December 31,			% Change	
	2008	**2007**	**2006**	**2008-2007**	**2007-2006**
Net interest income (GAAP)	$ 246,597	$ 240,129	$ 251,859	2.7	(4.7)
Tax-equivalent adjustment	22,225	20,906	23,551	6.3	(11.2)
Tax-equivalent net interest income	$ 268,822	$ 261,035	$ 275,410	3.0	(5.2)

Table 2 summarizes changes in our average interest-earning assets and interest-bearing liabilities over the last three years as well as interest income and interest expense related to each category of assets and funding sources and the average interest rates earned and paid on each. The table also shows the trend in net interest margin on a quarterly basis for 2008 and 2007, including the tax-equivalent yields on interest-earning assets and rates paid on interest-bearing liabilities. Table 3 details increases in income and expense for each of the major categories of interest-earning assets and analyzes the extent to which such variances are attributable to volume and rate changes. Interest income and yields are presented on a tax-equivalent basis assuming a federal income tax rate of 35%, which includes the tax-equivalent adjustment as presented in Table 1 above.

Net interest margin for 2008 was 3.61% compared to 3.58% for 2007. The net interest margins for both years, as well as the increase from 2007, reflect our strong core deposit base and our ability to effectively manage our cost of funds.

From 2007 to 2008, the yield received on our average interest-earning assets declined 102 basis points while our cost of funds declined 126 basis points. With approximately one-half of our loan portfolio tied to floating indices, the 400 basis-point decline in the Federal Reserve s federal funds rate during 2008 caused a decline of 151 basis points in average loan yields from 2007. The increase in non-accrual loans from 2007 to 2008 also negatively impacted the yield by six basis points. This negative impact was offset by a shift from time deposits to less expensive wholesale borrowings, including federal term auction facilities, a widening of loan spreads, and expanded earnings spreads on our predominately fixed-rate investment portfolio as interest rates fell.

We continue to use multiple interest rate scenarios to rigorously assess the direction and magnitude of changes in interest rates and their impact on net interest income. A description and analysis of our market risk and interest rate sensitivity profile and management policies is included in Item 7A, Quantitative and Qualitative Disclosures About Market Risk, of this Form 10-K.

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Table 2

Net Interest Income and Margin Analysis

(Dollar amounts in thousands)

	2008			2007			2006		
	Average Balance	**Interest**	**Yield/ Rate (%)**	**Average Balance**	**Interest**	**Yield/ Rate (%)**	**Average Balance**	**Interest**	**Yield/ Rate (%)**
Assets:									
Interest-bearing deposits with banks	$ 3,399	$ 52	1.53	$ 7,550	$ 383	5.07	$ 5,804	$ 252	4.34
Federal funds sold and securities purchased under agreements to resell	14,672	166	1.13	3,011	173	5.75	1,067	71	6.65
Mortgages held for sale	37	3	8.11	2,940	171	5.82	4,021	238	5.92
Securities:									
Trading - taxable	17,202	289	1.68	17,006	360	2.12	-	-	-
Available-for-sale - taxable	1,171,264	61,844	5.28	1,268,389	66,788	5.27	1,456,220	73,600	5.05
Available-for-sale - nontaxable [1]	936,933	57,344	6.12	906,905	54,755	6.04	998,727	63,112	6.32
Held-to-maturity - taxable	7,670	341	4.45	9,450	422	4.47	9,848	429	4.36
Held-to-maturity - nontaxable [1]	84,718	5,879	6.94	88,099	6,159	6.99	91,046	6,231	6.84
Total securities	2,217,787	125,697	5.67	2,289,849	128,484	5.61	2,555,841	143,372	5.61
Federal Home Loan Bank and Federal Reserve Bank stock	54,767	1,318	2.41	54,774	2,034	3.71	59,056	2,363	4.00
Loans [1][2]:									
Commercial and industrial	1,435,525	85,319	5.94	1,379,007	104,968	7.61	1,353,337	99,495	7.35
Agricultural	176,378	8,822	5.00	166,647	11,721	7.03	143,865	9,970	6.93
Commercial real estate	2,775,847	165,121	5.95	2,592,170	192,003	7.41	2,442,731	179,777	7.36
Consumer	547,965	31,771	5.80	596,885	44,978	7.54	702,269	50,820	7.24
Real estate - 1-4 family	214,164	13,163	6.15	208,770	12,952	6.20	227,158	13,602	5.99
Total loans	5,149,879	304,196	5.91	4,943,479	366,622	7.42	4,869,360	353,664	7.26
Total interest-earning assets [1][2]	7,440,541	431,432	5.80	7,301,603	497,867	6.82	7,495,149	499,960	6.67
Cash and due from banks	136,547			152,057			165,324		
Reserve for loan losses	(66,378)			(62,227)			(61,184)		
Other assets	714,730			699,900			656,475		
Total assets	$ 8,225,440			$ 8,091,333			$ 8,255,764		
Liabilities and Stockholders Equity:									
Savings deposits	$ 792,524	7,148	0.90	$ 754,009	11,844	1.57	$ 653,321	5,116	0.78
NOW accounts	935,429	9,637	1.03	900,956	14,536	1.61	924,539	13,102	1.42
Money market deposits	787,218	13,220	1.68	859,864	28,469	3.31	867,775	27,418	3.16
Total interest-bearing transactional deposits	2,515,171	30,005	1.19	2,514,829	54,849	2.18	2,445,635	45,636	1.87
Time deposits	2,172,379	80,617	3.71	2,319,902	111,418	4.80	2,429,902	102,482	4.22
Total interest-bearing deposits	4,687,550	110,622	2.36	4,834,731	166,267	3.44	4,875,537	148,118	3.04
Borrowed funds	1,438,908	37,192	2.58	1,131,700	55,540	4.91	1,339,826	62,974	4.70
Subordinated debt	231,961	14,796	6.38	227,756	15,025	6.60	206,449	13,458	6.52
Total interest-bearing liabilities	6,358,419	162,610	2.56	6,194,187	236,832	3.82	6,421,812	224,550	3.50
Demand deposits	1,043,972			1,055,251			1,052,413		

Other liabilities	58,318			91,784			86,519		
Stockholders equity	764,731			750,111			695,020		
Total liabilities and stockholders equity	$ 8,225,440			$ 8,091,333			$ 8,255,764		
Net interest income/margin [1]		$ 268,822	3.61		$ 261,035	3.58		$ 275,410	3.67

Quarterly Net Interest Margin Trend

	2008				2007			
	Fourth	**Third**	**Second**	**First**	**Fourth**	**Third**	**Second**	**First**
Yield on interest-earning assets	5.43%	5.69%	5.81%	6.29%	6.67%	6.91%	6.86%	6.83%
Rates paid on interest-bearing liabilities	2.03%	2.40%	2.61%	3.23%	3.71%	3.86%	3.84%	3.88%
Net interest margin [1]	3.71%	3.63%	3.58%	3.53%	3.53%	3.63%	3.61%	3.53%

(1) Interest income and yields are presented on a tax-equivalent basis, assuming a federal income tax rate of 35%.

(2) Loans on a non-accrual basis for the recognition of interest income totaled $127.8 million as of December 31, 2008, $18.4 million as of December 31, 2007, and $16.2 million as of December 31, 2006 and are included in loans for purposes of this analysis.

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Table 3

Changes in Net Interest Income Applicable to Volumes and Interest Rates [1]

(Dollar amounts in thousands)

	2008 compared to 2007			2007 compared to 2006		
	Volume	Rate	Total	Volume	Rate	Total
Interest-bearing deposits with banks	$ (146)	$ (185)	$ (331)	$ 84	$ 47	$ 131
Federal funds sold and securities purchased under agreements to resell	(9)	2	(7)	111	(9)	102
Mortgages held for sale	(278)	110	(168)	(63)	(4)	(67)
Securities:						
Trading - taxable	4	(75)	(71)	360	-	360
Available-for-sale - taxable	(5,129)	185	(4,944)	(9,979)	3,167	(6,812)
Available-for-sale - nontaxable [2]	1,831	758	2,589	(5,628)	(2,729)	(8,357)
Held-to-maturity - taxable	(79)	(2)	(81)	(20)	13	(7)
Held-to-maturity - nontaxable [2]	(235)	(45)	(280)	(214)	142	(72)
Total securities	(3,608)	821	(2,787)	(15,481)	593	(14,888)
Federal Home Loan Bank and Federal Reserve Bank stock	-	(716)	(716)	(165)	(164)	(329)
Loans [2]:						
Commercial and industrial	4,519	(24,168)	(19,649)	1,910	3,563	5,473
Agricultural	734	(3,633)	(2,899)	1,600	151	1,751
Commercial real estate	15,111	(41,993)	(26,882)	11,480	746	12,226
Consumer	(3,463)	(9,744)	(13,207)	(8,061)	2,219	(5,842)
Real estate - 1-4 family	330	(119)	211	(1,173)	523	(650)
Total loans	17,231	(79,657)	(62,426)	5,756	7,202	12,958
Total interest income [2]	13,190	(79,625)	(66,435)	(9,758)	7,665	(2,093)
Savings deposits	640	(5,336)	(4,696)	893	5,835	6,728
NOW accounts	580	(5,479)	(4,899)	(324)	1,758	1,434
Money market deposits	(2,232)	(13,017)	(15,249)	(247)	1,298	1,051
Total interest-bearing transactional deposits	(1,012)	(23,832)	(24,844)	322	8,891	9,213
Time deposits	(6,733)	(24,068)	(30,801)	(4,327)	13,263	8,936
Total interest-bearing deposits	(7,745)	(47,900)	(55,645)	(4,005)	22,154	18,149
Borrowed funds	24,673	(43,021)	(18,348)	(10,386)	2,952	(7,434)
Subordinated debt	288	(517)	(229)	1,404	163	1,567