
**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION**
Washington, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2016

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 001-35272

MIDLAND STATES BANCORP, INC.

(Exact name of Registrant as specified in its charter)

ILLINOIS

(State of other jurisdiction of incorporation or organization)

37-1233196

(I.R.S. Employer Identification No.)

**1201 Network Centre Drive
Effingham, IL**

(Address of principal executive offices)

62401

(Zip Code)

(217) 342-7321

(Registrant's telephone number, including area code)

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company

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

As of October 31, 2016, the Registrant had 15,415,747 shares of outstanding common stock, \$0.01 par value.

Midland States Bancorp, Inc.

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Part I – Financial Information

Item 1 – Financial Statements

Midland States Bancorp, Inc.

Consolidated Balance Sheets

(dollars expressed in thousands, except for per share data)

	September 30, 2016 (unaudited)	December 31, 2015
Assets		
Cash and due from banks	\$ 227,496	\$ 211,976
Federal funds sold	534	499
Cash and cash equivalents	228,030	212,475
Investment securities available for sale, at fair value (\$72,093 and \$75,979 covered by a FDIC loss-share agreement at September 30, 2016 and December 31, 2015, respectively)	252,212	236,627
Investment securities held to maturity, at amortized cost (fair value of \$88,590 and \$92,816 at September 30, 2016 and December 31, 2015, respectively)	82,941	87,521
Loans	2,312,778	1,995,589
Allowance for loan losses	(15,559)	(15,988)
Total loans, net	2,297,219	1,979,601
Loans held for sale, at fair value	61,363	54,413
Premises and equipment, net	70,727	73,133
Other real estate owned	4,828	5,472
Nonmarketable equity securities	18,810	15,472
Accrued interest receivable	8,811	7,697
Mortgage servicing rights, at lower of cost or market	64,689	66,651
Intangible assets	5,391	7,004
Goodwill	46,519	46,519
Cash surrender value of life insurance policies	74,276	52,729
Accrued income taxes receivable	1,450	8,754
Deferred tax assets, net	—	1,496
Other assets	30,461	29,260
Total assets	<u>\$ 3,247,727</u>	<u>\$ 2,884,824</u>
Liabilities and Shareholders' Equity		
Liabilities:		
Deposits:		
Noninterest-bearing	\$ 629,113	\$ 543,401
Interest-bearing	1,790,919	1,824,247
Total deposits	2,420,032	2,367,648
Short-term borrowings	138,289	107,538
FHLB advances and other borrowings	237,543	40,178
Subordinated debt	54,484	61,859
Trust preferred debentures	37,316	37,057
Accrued interest payable	1,875	979
Deferred tax liabilities, net	3,216	—
Other liabilities	33,182	36,509
Total liabilities	<u>2,925,937</u>	<u>2,651,768</u>
Shareholders' Equity:		
Common stock, \$0.01 par value; 40,000,000 shares authorized; 15,404,423 and 11,797,404 shares issued and outstanding at September 30, 2016 and December 31, 2015, respectively	154	118
Capital surplus	208,452	135,822
Retained earnings	103,813	90,911
Accumulated other comprehensive income	9,330	6,029
Total Midland States Bancorp, Inc. shareholders' equity	321,749	232,880
Noncontrolling interest in subsidiaries	41	176
Total shareholders' equity	<u>321,790</u>	<u>233,056</u>
Total liabilities and shareholders' equity	<u>\$ 3,247,727</u>	<u>\$ 2,884,824</u>

See accompanying notes to consolidated financial statements

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Midland States Bancorp, Inc.
Consolidated Statements of Income (Unaudited)
(dollars expressed in thousands, except for per share data)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Interest income:				
Loans:				
Taxable	\$ 26,905	\$ 24,807	\$ 78,142	\$ 74,821
Tax exempt	254	309	899	852
Investment securities:				
Taxable	2,940	2,784	8,726	8,589
Tax exempt	892	967	2,739	2,972
Federal funds sold and cash investments	195	82	762	262
Total interest income	<u>31,186</u>	<u>28,949</u>	<u>91,268</u>	<u>87,496</u>
Interest expense:				
Deposits	2,189	1,921	6,701	5,320
Short-term borrowings	81	56	217	176
FHLB advances and other borrowings	306	111	698	634
Subordinated debt	873	1,054	2,985	1,671
Trust preferred debentures	472	370	1,373	1,240
Total interest expense	<u>3,921</u>	<u>3,512</u>	<u>11,974</u>	<u>9,041</u>
Net interest income	<u>27,265</u>	<u>25,437</u>	<u>79,294</u>	<u>78,455</u>
Provision for loan losses				
Net interest income after provision for loan losses	<u>25,873</u>	<u>18,738</u>	<u>76,148</u>	<u>68,380</u>
Noninterest income:				
Commercial FHA revenue	3,260	5,914	18,360	17,130
Residential mortgage banking revenue	4,990	3,490	7,148	14,305
Wealth management revenue	1,941	1,808	5,596	5,461
Merchant services revenue	427	419	1,287	1,097
Service charges on deposit accounts	1,044	1,022	2,916	2,990
Interchange revenue	920	895	2,829	2,703
FDIC loss-sharing expense	—	(57)	(1,661)	(354)
Gain on sales of investment securities, net	39	1	315	160
Other-than-temporary impairment on investment securities	—	(299)	(824)	(461)
Gain on sales of other real estate owned	33	92	112	417
Other income	2,283	1,179	5,494	3,235
Total noninterest income	<u>14,937</u>	<u>14,464</u>	<u>41,572</u>	<u>46,683</u>
Noninterest expense:				
Salaries and employee benefits	16,568	14,932	48,967	49,588
Occupancy and equipment	3,271	3,114	9,815	9,727
Data processing	2,586	2,541	7,830	7,651
FDIC insurance	388	371	1,350	1,514
Professional	1,877	2,075	5,151	6,608
Marketing	717	855	2,009	2,247
Communications	546	506	1,609	1,791
Loan expense	314	789	1,351	2,349
Other real estate owned	179	203	748	660
Amortization of intangible assets	514	597	1,613	1,863
Other	1,703	1,840	6,762	6,073
Total noninterest expense	<u>28,663</u>	<u>27,823</u>	<u>87,205</u>	<u>90,071</u>
Income before income taxes	<u>12,147</u>	<u>5,379</u>	<u>30,515</u>	<u>24,992</u>
Income taxes				
Net income	<u>8,045</u>	<u>3,451</u>	<u>19,953</u>	<u>16,711</u>
Less: net (loss) income attributable to noncontrolling interest in subsidiaries				
Net income attributable to Midland States Bancorp, Inc.	<u>\$ 8,051</u>	<u>\$ 3,445</u>	<u>\$ 19,959</u>	<u>\$ 16,629</u>
Per common share data:				
Basic earnings per common share	\$ 0.51	\$ 0.29	\$ 1.46	\$ 1.39
Diluted earnings per common share	\$ 0.51	\$ 0.28	\$ 1.43	\$ 1.36
Weighted average common shares outstanding	15,578,703	11,911,414	13,637,997	11,895,337
Weighted average diluted common shares outstanding	15,858,273	12,130,529	13,902,664	12,111,695

See accompanying notes to consolidated financial statements

Midland States Bancorp, Inc.

Consolidated Statements of Comprehensive Income (Unaudited)

(dollars expressed in thousands)

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2016	2015	2016	2015
Net income	\$ 8,045	\$ 3,451	\$ 19,953	\$ 16,711
Other comprehensive (loss) income:				
Investment securities available for sale:				
Unrealized (losses) gains that occurred during the period	(233)	2,136	5,789	222
Reclassification adjustment for realized net gains on sales of investment securities included in net income	(39)	(1)	(315)	(160)
Income tax effect	110	(859)	(2,203)	(25)
Change in investment securities available for sale, net of tax	<u>(162)</u>	<u>1,276</u>	<u>3,271</u>	<u>37</u>
Investment securities held to maturity:				
Amortization of unrealized gain on investment securities transferred from available-for-sale	(3)	(49)	(42)	(187)
Income tax effect	1	20	17	103
Change in investment securities held to maturity, net of tax	<u>(2)</u>	<u>(29)</u>	<u>(25)</u>	<u>(84)</u>
Cash flow hedges:				
Change in fair value of interest rate swap	32	21	93	56
Income tax effect	(13)	(13)	(38)	(25)
Change in cash flow hedges, net of tax	<u>19</u>	<u>8</u>	<u>55</u>	<u>31</u>
Other comprehensive (loss) income, net of tax	<u>(145)</u>	<u>1,255</u>	<u>3,301</u>	<u>(16)</u>
Total comprehensive income	7,900	4,706	23,254	16,695
Less: net (loss) income attributable to noncontrolling interest in subsidiaries	(6)	6	(6)	82
Total comprehensive income attributable to Midland States Bancorp, Inc.	<u>\$ 7,906</u>	<u>\$ 4,700</u>	<u>\$ 23,260</u>	<u>\$ 16,613</u>

See accompanying notes to consolidated financial statements

Midland States Bancorp, Inc.
Consolidated Statements of Shareholders' Equity (Unaudited)
Nine Months Ended September 30, 2016 and 2015
(dollars expressed in thousands, except for per share data)

	Common stock	Capital surplus	Retained earnings	Accumulated other comprehensive income	Midland States Bancorp, Inc.'s Shareholders' Equity	Noncontrolling interests in subsidiaries	Total
Balances, December 31, 2015	\$ 118	\$ 135,822	\$ 90,911	\$ 6,029	\$ 232,880	\$ 176	\$ 233,056
Net income	—	—	19,959	—	19,959	(6)	19,953
Cash distributions to noncontrolling interests	—	—	—	—	—	(129)	(129)
Compensation expense for stock option grants	—	315	—	—	315	—	315
Amortization of restricted stock awards	—	387	—	—	387	—	387
Common dividends declared (\$0.54 per share)	—	—	(7,057)	—	(7,057)	—	(7,057)
Initial public offering of 3,590,065 shares of common stock, net of issuance costs	36	71,439	—	—	71,475	—	71,475
Issuance of common stock under employee benefit plans	—	489	—	—	489	—	489
Other comprehensive income	—	—	—	3,301	3,301	—	3,301
Balances, September 30, 2016	<u>\$ 154</u>	<u>\$ 208,452</u>	<u>\$ 103,813</u>	<u>\$ 9,330</u>	<u>\$ 321,749</u>	<u>\$ 41</u>	<u>\$ 321,790</u>
Balances, December 31, 2014	\$ 117	\$ 134,423	\$ 74,279	\$ 10,637	\$ 219,456	\$ 473	\$ 219,929
Net income	—	—	16,629	—	16,629	82	16,711
Cash distributions to noncontrolling interests	—	—	—	—	—	(345)	(345)
Compensation expense for stock option grants	—	287	—	—	287	—	287
Amortization of restricted stock awards	—	389	—	—	389	—	389
Common dividends declared (\$0.48 per share)	—	—	(5,680)	—	(5,680)	—	(5,680)
Issuance of common stock under employee benefit plans	1	349	—	—	350	—	350
Other comprehensive loss	—	—	—	(16)	(16)	—	(16)
Balances, September 30, 2015	<u>\$ 118</u>	<u>\$ 135,448</u>	<u>\$ 85,228</u>	<u>\$ 10,621</u>	<u>\$ 231,415</u>	<u>\$ 210</u>	<u>\$ 231,625</u>

See accompanying notes to consolidated financial statements.

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Midland States Bancorp, Inc.
Consolidated Statements of Cash Flows (Unaudited)
(dollars expressed in thousands)

	Nine Months Ended September 30,	
	2016	2015
Cash flows from operating activities:		
Net income	\$ 19,953	\$ 16,711
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	3,146	10,075
Depreciation on premises and equipment	3,816	3,791
Amortization of intangible assets	1,613	1,863
FDIC loss-sharing expense	1,661	354
Amortization of restricted stock awards	387	389
Compensation expense for stock option grants	315	287
Increase in cash surrender value of life insurance	(1,547)	(1,016)
Investment securities amortization, net	840	905
Other-than-temporary impairment on investment securities	824	461
Gain on sales of investment securities, net	(315)	(160)
Gain on sales of other real estate owned	(112)	(417)
Write-down of other real estate owned	219	49
Origination of loans held for sale	(894,445)	(779,821)
Proceeds from sales of loans held for sale	907,306	836,133
Gain on loans sold and held for sale	(28,827)	(29,557)
Amortization of mortgage servicing rights	4,410	3,739
Impairment on mortgage servicing rights	6,093	676
Net change in operating assets and liabilities:		
Accrued interest receivable	(1,114)	(150)
Accrued interest payable	896	823
Accrued income taxes receivable	7,304	(2,193)
Other assets	460	2,776
Other liabilities	(2,485)	5,945
Net cash provided by operating activities	<u>30,398</u>	<u>71,663</u>
Cash flows from investing activities:		
Investment securities available for sale:		
Purchases	(64,396)	(43,244)
Sales	31,191	61,629
Maturities and payments	22,038	23,306
Investment securities held to maturity:		
Purchases	(2,401)	(603)
Maturities	6,646	9,818
Net increase in loans	(325,009)	(184,955)
Purchases of premises and equipment	(1,410)	(4,875)
Purchase of bank-owned life insurance	(20,000)	(20,000)
Purchases of nonmarketable equity securities	(3,428)	(5,311)
Sales of nonmarketable equity securities	90	1,918
Proceeds from sales of other real estate owned	4,423	4,886
Net cash paid in acquisitions	—	(20,053)
Net cash used in investing activities	<u>(352,256)</u>	<u>(177,484)</u>
Cash flows from financing activities:		
Net increase in deposits	52,384	147,953
Net increase (decrease) in short-term borrowings	30,751	(20,891)
Proceeds from FHLB borrowings	850,000	47,500
Payments made on FHLB borrowings	(652,500)	(57,500)
Payments made on other borrowings	—	(14,130)
Proceeds from issuance of subordinated debt, net of issuance costs	—	55,325
Payments made on subordinated debt	(8,000)	—
Cash dividends paid on common stock	(7,057)	(5,680)
Proceeds from issuance of common stock in initial public offering, net of issuance costs	71,475	—
Proceeds from issuance of common stock under employee benefit plans	489	350
Cash distributions to noncontrolling interests	(129)	(345)
Net cash provided by financing activities	<u>337,413</u>	<u>152,582</u>
Net increase in cash and cash equivalents	<u>15,555</u>	<u>46,761</u>
Cash and cash equivalents:		
Beginning of year	\$ 212,475	\$ 159,903
End of year	<u>\$ 228,030</u>	<u>\$ 206,664</u>
Supplemental disclosures of cash flow information:		
Cash payments for:		
Interest paid on deposits and borrowed funds	\$ 11,078	\$ 8,218
Income tax paid	157	10,091
Supplemental disclosures of noncash investing and financing activities:		
Transfer of loans to other real estate owned	\$ 4,245	\$ 2,908

See accompanying notes to consolidated financial statements

Midland States Bancorp, Inc.

Notes to Consolidated Financial Statements (Unaudited)

Note 1 – Business Description

Midland States Bancorp, Inc. (“the Company,” “we,” “our,” or “us”) is a diversified financial holding company headquartered in Effingham, Illinois. Our 135-year old banking subsidiary, Midland States Bank (the “Bank”), has branches across Illinois and in Missouri and Colorado, and provides traditional community banking and other complementary financial services, including lending, residential mortgage origination, wealth management, merchant services and prime consumer lending. We also originate and service government sponsored mortgages for multifamily and healthcare facilities and operate a commercial equipment leasing business on a nationwide basis.

Since late 2007, we have grown organically and through a series of nine acquisitions. Most recently, we acquired Love Savings Holding Company (“LSHC”) in December 2014, which greatly expanded our commercial and retail banking services in the St. Louis metropolitan area, added a branch and three mortgage offices in Colorado, and provided us the opportunity to enter complementary lending and leasing business lines.

Our principal business activity has been lending to and accepting deposits from individuals, businesses, municipalities and other entities. We have derived income principally from interest charged on loans and, to a lesser extent, from interest and dividends earned on investment securities. We have also derived income from noninterest sources, such as: fees received in connection with various lending and deposit services; wealth management services; residential mortgage loan originations, sales and servicing; merchant services; and, from time to time, gains on sales of assets. With the acquisition of LSHC, we expanded our income sources to include a greater emphasis on residential mortgage loan origination and servicing, Love Funding Corporation’s (“Love Funding”) commercial Federal Housing Administration (“FHA”) loan origination and servicing, and Heartland Business Credit Corporation’s (“Business Credit”) interest income on indirect financing leases. Our principal expenses include interest expense on deposits and borrowings, operating expenses, such as salaries and employee benefits, occupancy and equipment expenses, data processing costs, professional fees and other noninterest expenses, provisions for loan losses and income tax expense.

Initial Public Offering

On May 24, 2016, we completed our initial public offering and received gross proceeds of \$67.0 million for the 3,044,252 shares of common stock sold by us in the offering. On June 6, 2016, we received additional gross proceeds of \$12.0 million for the 545,813 shares of common stock sold when the underwriters fully exercised their option to purchase additional shares of common stock. After deducting underwriting discounts and offering expenses, we received total net proceeds of \$71.5 million from the initial public offering.

Note 2 – Basis of Presentation and Summary of Significant Accounting Policies

Basis of Presentation

The accompanying unaudited consolidated financial statements of the Company have been prepared in accordance with U.S. generally accepted accounting principles (“GAAP”). These interim financial statements should be read in conjunction with our audited consolidated financial statements and the notes thereto as of and for the years ended December 31, 2015, 2014 and 2013, included in our registration statement on Form S-1 filed with the Securities and Exchange Commission (“SEC”) on May 23, 2016.

Principles of Consolidation

The consolidated financial statements include the accounts of the parent company and its subsidiaries, giving effect to the noncontrolling interest in subsidiaries, as more fully described below. All significant intercompany accounts and transactions have been eliminated. Assets held for customers in a fiduciary or agency capacity, other than trust cash on deposit with the Bank, are not assets of the Company and, accordingly, are not included in the accompanying unaudited consolidated financial statements.

The Company operates through its wholly owned subsidiary bank, Midland States Bank, headquartered in Effingham, Illinois. The Bank operates through its branch banking offices and subsidiaries: Love Funding, Business Credit, and Heartland Premier LLC (“Premier”). All of the subsidiaries are wholly owned by the Bank as of September 30, 2016, except for Premier, which was formed as a joint venture mortgage origination operation, of which the Bank owns 51% and acts as a manager. Heartland Preferred Mortgage Company LLC (“Preferred”), formerly a subsidiary of the Bank, was a joint venture mortgage origination operation, of which the Bank owned 51% and acted as a manager.

Midland States Bancorp, Inc.

Notes to Consolidated Financial Statements (Unaudited) (Continued)

Preferred was dissolved on May 27, 2016. Premier and Preferred are included in the consolidated financial statements and the noncontrolling ownership interest is reported as a component of shareholders' equity in the consolidated balance sheets as "noncontrolling interest in subsidiaries" and the earnings or loss attributable to the noncontrolling ownership interest is reported as "net (loss) income attributable to noncontrolling interest in subsidiaries" in the consolidated statements of income.

Use of Estimates

In preparing the consolidated financial statements, we are required to make estimates and assumptions, which significantly affect the amounts reported in the consolidated financial statements. Significant estimates that are particularly susceptible to change include the fair value of investment securities, the determination of the allowance for loan losses, estimated fair values of purchased loans, valuation of real estate and other properties acquired in connection with foreclosures or in satisfaction of amounts due from borrowers on loans, and the carrying value of mortgage servicing rights. While management uses its best judgment, actual results may differ from those estimates. Current economic and market conditions significantly affect the judgments.

Summary of Significant Accounting Policies

The accompanying consolidated financial statements were compiled in accordance with the accounting policies set forth in Note 1 – Summary of Significant Accounting Policies of the Notes to Consolidated Financial Statements in our consolidated financial statements as of and for the periods ended December 31, 2015, 2014 and 2013, included in our registration statement on Form S-1 filed with the SEC on May 23, 2016. The accompanying consolidated financial statements reflect all adjustments, consisting of normal recurring adjustments that, in the opinion of management, are necessary to reflect a fair statement of our consolidated financial condition, results of operations and cash flows. The results of operations for acquired companies are included from the dates of acquisition. Operating results for the three and nine months ended September 30, 2016 are not necessarily indicative of the results that may be expected for the year ending December 31, 2016.

Impact of New Financial Accounting Standards

FASB ASU 2014-09, "Revenue from Contracts with Customers (Topic 606)" – In May 2014, the Financial Accounting Standards Board (the "FASB") issued Accounting Standards Update ("ASU") No. 2014-09, "*Revenue from Contracts with Customers (Topic 606)*." The ASU supersedes revenue recognition requirements in Topic 605, *Revenue Recognition*, including most industry-specific revenue recognition guidance in the FASB Accounting Standards Codification ("ASC"). The ASU requires an entity to recognize revenue that depicts the transfer of promised goods or services to customers in an amount reflecting the consideration the entity expects to receive in exchange for those goods or services. The ASU identifies specific steps that entities should apply to achieve this principle. The new guidance was originally effective for fiscal years (including interim periods within those fiscal years) beginning after December 15, 2016 for public companies. In August 2015, the FASB issued ASU 2015-14, which defers the effective date of this guidance to annual reporting periods beginning after December 15, 2017 for public companies, and permits early adoption on a limited basis. The Company is currently evaluating the new guidance and has not determined the impact this standard may have on its consolidated financial statements. Entities have the option of using either a full retrospective or modified approach to adopt ASU 2014-09.

FASB ASU 2016-02, "Leases (Topic 842)" - In February 2016, the FASB issued ASU No. 2016-02, "*Leases (Topic 842)*." This update revises the model to assess how a lease should be classified and provides guidance for lessees and lessors, when presenting right-of-use assets and lease liabilities on the balance sheet. The update is effective for the Company for the year ending December 31, 2019, although the Company may elect to adopt guidance earlier. The Company is currently evaluating the new guidance and has not determined the impact this standard may have on its consolidated financial statements.

FASB ASU 2016-08, "Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations (Reporting Revenue Gross versus Net)" – In March 2016, the FASB issued ASU No. 2016-08, "*Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations (Reporting Revenue Gross versus Net)*." The amendments relate to when another party, along with the entity, is involved in providing a good or service to a customer. The ASU requires an entity to determine whether the nature of its promise is to provide that good or service to the customer (that is, the entity is a principal) or to arrange for the good or service to be provided to

Midland States Bancorp, Inc.

Notes to Consolidated Financial Statements (Unaudited) (Continued)

the customer by the other party (that is, the entity is an agent). This determination is based upon whether the entity controls the good or the service before it is transferred to the customer. Topic 606 includes indicators to assist in this evaluation. The amendments in this update affect the guidance in ASU No. 2014-09 above, which is not yet effective. The effective date will be the same as the effective date of ASU No. 2014-09. The Company is currently evaluating the new guidance and has not determined the impact this standard may have on its consolidated financial statements.

FASB ASU 2016-09, “Compensation-Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting” - In March 2016, the FASB issued ASU No. 2016-09, “*Compensation—Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting.*” This update includes multiple provisions intended to simplify various aspects of the accounting for share-based payments. While aimed at reducing the cost and complexity of the accounting for share-based payments, the amendments are expected to significantly impact net income, earnings per share, and the statement of cash flows. Implementation and administration may present challenges for companies with significant share-based payment activities. For public companies, the amendments in this update are effective for fiscal years beginning after December 15, 2016, and interim periods within those fiscal years. Early application is permitted for any organization in any interim period or fiscal year. The Company is currently evaluating the new guidance and has not determined the impact this standard may have on its consolidated financial statements.

FASB ASU 2016-10, “Revenue from Contracts with Customers (Topic 606): Identifying Performance Obligations and Licensing” – In April 2016, the FASB issued ASU No. 2016-10, “*Revenue from Contracts with Customers (Topic 606): Identifying Performance Obligations and Licensing.*” The amendments clarify the following two aspects of Topic 606: identifying performance obligations, and the licensing implementation guidance. Before an entity can identify its performance obligations in a contract with a customer, the entity first identifies the promised goods or services in the contract. The amendments in this update are expected to reduce the cost and complexity of applying the guidance on identifying promised goods or services. To identify performance obligations in a contract, an entity evaluates whether promised goods and services are distinct. Topic 606 includes two criteria for assessing whether promises to transfer goods or services are distinct. One of those criteria is that the promises are separately identifiable. This update will improve the guidance on assessing that criterion. Topic 606 also includes implementation guidance on determining whether an entity’s promise to grant a license provides a customer with either a right to use the entity’s intellectual property, which is satisfied at a point in time, or a right to access the entity’s intellectual property, which is satisfied over time. The amendments in this update are intended to improve the operability and understandability of the licensing implementation guidance. The amendments in this update affect the guidance in ASU No. 2014-09 above, which is not yet effective. The effective date will be the same as the effective date of ASU No. 2014-09. The Company is currently evaluating the new guidance and has not determined the impact this standard may have on its consolidated financial statements.

FASB ASU 2016-13, “Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments” – In June 2016, the FASB issued ASU No. 2016-13, “*Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments.*” The objective of this update is to improve financial reporting by providing timelier recording of credit losses on loans and other financial instruments held by financial institutions and other organizations. The ASU requires an organization to measure all expected credit losses for financial assets held at the reporting date based on historical experience, current conditions, and reasonable and supportable forecasts. Financial institutions and other organizations will now use forward-looking information to better understand their credit loss estimates. For public companies that are SEC filers, this update is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019. Early application is permitted for any organization for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. The Company is currently evaluating the new guidance and has not determined the impact this standard may have on its consolidated financial statements.

FASB ASU 2016-15, “Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments” – In August 2016, the FASB issued ASU No. 2016-15, “*Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments,*” which amends ASC 230 to add or clarify guidance on the classification of certain cash receipts and payments in the statement of cash flows. For public business entities, this update is effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2017. Early application is permitted for any organization in any interim period or fiscal year. The Company is currently

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Notes to Consolidated Financial Statements (Unaudited) (Continued)

evaluating the new guidance and has not determined the impact this standard may have on its consolidated financial statements.

Note 3 – Acquisitions

On December 31, 2014, the Company completed its acquisition of LSHC. At closing, LSHC primarily consisted of Heartland Bank, its wholly owned subsidiaries Love Funding and Business Credit, and \$40.0 million of trust preferred debentures. Heartland Bank provided commercial and retail banking services in the St. Louis metropolitan area, its primary market, through the operation of 10 full-service banking offices, a full-service cyber office, three limited service loan production offices, and a retirement center office in Missouri, and one branch office in Colorado. Love Funding is an approved FHA insured lender and Government National Mortgage Association issuer engaged in commercial mortgage origination and servicing, and Business Credit provides custom leasing and financing programs to equipment and software vendors.

The Company acquired LSHC for \$67.3 million, which consisted of 2,224,091 shares of common stock, \$20.1 million in cash and an accrual in other liabilities of \$530,000 for the fair value of additional consideration based on the earnings of Love Funding over a two year period after acquisition date. The additional consideration is defined as the amount, if any, by which 50% of Love Funding’s adjusted net income (for the two year period ending December 31, 2016) exceeds \$9.1 million, multiplied by an earn-out multiple. The contingent consideration amount is capped at \$12.0 million and any payment will be made through issuance of the Company’s common stock.

The acquired identifiable assets included the establishment of a \$3.4 million core deposit intangible, which is being amortized on an accelerated basis over 10 years. The Company also recognized \$0.5 million for the fair value of noncontrolling interests associated with two mortgage origination joint ventures owned 51% by Heartland Bank.

Pending Acquisition at September 30, 2016

On February 23, 2016, the Bank and Sterling National Bank of Yonkers, New York (“Sterling”) entered into a Trust Company Agreement and Plan of Merger (“Merger Agreement”), pursuant to which the Bank will acquire approximately \$400.0 million in wealth management assets from Sterling. Under the terms of the Merger Agreement, the Bank will pay Sterling approximately \$4.8 million in cash, with an expected closing date in the fourth quarter of 2016. The transaction is subject to regulatory approval and other customary closing conditions.

Note 4 – Investment Securities Available for Sale

Investment securities classified as available for sale as of September 30, 2016 and December 31, 2015 are as follows (in thousands):

	September 30, 2016			
	Amortized cost	Gross unrealized gains	Gross unrealized losses	Fair value
U.S. Treasury securities	\$ 35,499	\$ 13	\$ 6	\$ 35,506
Government sponsored entity debt securities	8,788	202	—	8,990
Agency mortgage-backed securities	67,536	1,134	14	68,656
Non-agency mortgage-backed securities	1	—	—	1
Covered non-agency mortgage-backed securities ⁽¹⁾	58,376	14,386	669	72,093
State and municipal securities	21,724	271	15	21,980
Corporate securities	44,853	526	393	44,986
Total	<u>\$ 236,777</u>	<u>\$ 16,532</u>	<u>\$ 1,097</u>	<u>\$ 252,212</u>

(1) All covered non-agency mortgage-backed securities were covered under the loss-sharing agreement we entered into with the Federal Deposit Insurance Corporation (the “FDIC”) in connection with a 2009 acquisition. This agreement had a seven year term that expired on July 1, 2016 with respect to losses. On October 3, 2016, the Company entered into an agreement with the FDIC to terminate its existing loss share agreements as more fully described in Note 21 to the Consolidated Financial Statements. None of our other investment securities were covered under a loss-sharing agreement with the FDIC.

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Notes to Consolidated Financial Statements (Unaudited) (Continued)

	December 31, 2015			
	Amortized cost	Gross unrealized gains	Gross unrealized losses	Fair value
U.S. Treasury securities	\$ 48,483	\$ 1	\$ 182	\$ 48,302
Government sponsored entity debt securities	9,404	58	8	9,454
Agency mortgage-backed securities	66,902	835	210	67,527
Non-agency mortgage-backed securities	2	—	—	2
Covered non-agency mortgage-backed securities ⁽¹⁾	66,397	10,886	1,304	75,979
State and municipal securities	15,441	77	24	15,494
Corporate securities	20,036	28	195	19,869
Total	\$ 226,665	\$ 11,885	\$ 1,923	\$ 236,627

(1) All covered non-agency mortgage-backed securities were covered under the loss-sharing agreement we entered into with the FDIC in connection with a 2009 acquisition. This agreement had a seven year term that expired on July 1, 2016 with respect to losses. On October 3, 2016, the Company entered into an agreement with the FDIC to terminate its existing loss share agreements as more fully described in Note 21 to the Consolidated Financial Statements. None of our other investment securities were covered under a loss-sharing agreement with the FDIC.

Market valuations for our investment securities classified as available for sale are provided by independent third parties. The fair values are determined using several sources for valuing fixed income securities. Their techniques include pricing models that vary based on the type of asset being valued and incorporate available trade, bid and other market information. The market valuation sources include observable market inputs for the majority of our securities and are therefore considered Level 2 inputs for the purpose of determining fair values. The fair values for U.S. Treasury securities are determined using quoted market prices and are considered Level 1.

Unrealized losses and fair values for investment securities available for sale as of September 30, 2016 and December 31, 2015, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, are summarized as follows (in thousands):

	September 30, 2016					
	Less than 12 Months		12 Months or more		Total	
	Fair value	Unrealized loss	Fair value	Unrealized loss	Fair value	Unrealized loss
U.S. Treasury securities	\$17,994	\$ 6	\$ —	\$ —	\$17,994	\$ 6
Government sponsored entity debt securities	—	—	—	—	—	—
Agency mortgage-backed securities	5,066	14	—	—	5,066	14
Covered non-agency mortgage-backed securities	429	27	4,895	642	5,324	669
State and municipal securities	3,417	15	—	—	3,417	15
Corporate securities	10,896	386	2,984	7	13,880	393
Total	\$37,802	\$ 448	\$7,879	\$ 649	\$45,681	\$ 1,097

	December 31, 2015					
	Less than 12 Months		12 Months or more		Total	
	Fair value	Unrealized loss	Fair value	Unrealized loss	Fair value	Unrealized loss
U.S. Treasury securities	\$42,301	\$ 182	\$ —	\$ —	\$ 42,301	\$ 182
Government sponsored entity debt securities	4,229	8	—	—	4,229	8
Agency mortgage-backed securities	19,404	167	1,932	43	21,336	210
Covered non-agency mortgage-backed securities	14,149	1,114	1,431	190	15,580	1,304
State and municipal securities	4,959	20	812	4	5,771	24
Corporate securities	11,245	172	813	23	12,058	195
Total	\$96,287	\$ 1,663	\$4,988	\$ 260	\$101,275	\$ 1,923

For all of the above investment securities, the unrealized losses are generally due to changes in interest rates and continued financial market stress, and unrealized losses are considered to be temporary.

We evaluate securities for other-than-temporary impairment (“OTTI”) on a quarterly basis, at a minimum, and more frequently when economic or market concerns warrant such evaluation. In estimating OTTI losses, we consider the severity and duration of the impairment; the financial condition and near-term prospects of the issuer, which for debt securities considers external credit ratings and recent downgrades; projected cash flows on non-agency mortgage-backed

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Notes to Consolidated Financial Statements (Unaudited) (Continued)

securities; and the intent and ability of the Company to hold the security for a period of time sufficient for a recovery in value.

At September 30, 2016 and December 31, 2015, 30 and 54 available-for-sale securities, respectively, had unrealized losses with aggregate depreciation of 2.35% and 1.86%, respectively, from their amortized cost basis. The unrealized losses relate principally to the fluctuations in the current interest rate environment. In analyzing an issuer's financial condition, we consider whether the securities are issued by the federal government or its agencies and whether downgrades by bond rating agencies have occurred. As we have the intent and ability to hold debt securities for a period of time sufficient for a recovery in value, no declines are deemed to be other-than-temporary.

During the three months ended September 30, 2016, there was no OTTI recognized. During the nine months ended September 30, 2016, the Company determined that three covered non-agency mortgage-backed securities had OTTI of \$824,000, primarily resulting from changes in expected cash flows. These amounts were recognized as losses in the consolidated statements of income.

During the three months ended September 30, 2015, the Company determined that two covered non-agency mortgage-backed securities had OTTI of \$299,000, primarily resulting from changes in expected cash flows. During the nine months ended September 30, 2015, the Company determined that three covered non-agency mortgage-backed securities had OTTI of \$461,000, primarily resulting from changes in expected cash flows. These amounts were recognized as losses in the consolidated statements of income.

The following is a summary of the amortized cost and fair value of available-for-sale investment securities, by maturity, at September 30, 2016 (in thousands). The maturities of agency, non-agency and covered non-agency mortgage-backed securities are based on expected maturities. Expected maturities may differ from contractual maturities in mortgage-backed securities because the mortgages underlying the securities may be prepaid without any penalties. The maturities of all other available-for-sale investment securities are based on final contractual maturity.

	Amortized cost	Fair value
Within one year	\$ 46,521	\$ 46,450
After one year through five years	109,963	120,369
After five years through ten years	64,747	68,130
After ten years	15,546	17,263
Total	<u>\$ 236,777</u>	<u>\$ 252,212</u>

Gross realized gains from the sale of securities available for sale were \$39,000 and \$315,000 for the three and nine months ended September 30, 2016, respectively. There were no gross realized losses for the three or nine months ended September 30, 2016.

Gross realized gains from the sale of securities available for sale were \$1,000 and \$335,000 for the three and nine months ended September 30, 2015, respectively. Gross realized losses were \$175,000 for the nine months ended September 30, 2015. There were no gross realized losses for the three months ended September 30, 2015.

Note 5 – Investment Securities Held to Maturity

Investment securities classified as held to maturity as of September 30, 2016 and December 31, 2015 are as follows (in thousands):

	September 30, 2016			
	Amortized cost	Gross unrealized gains	Gross unrealized losses	Fair value
State and municipal securities	\$ 82,941	\$ 5,724	\$ 75	\$ 88,590

	December 31, 2015			
	Amortized cost	Gross unrealized gains	Gross unrealized losses	Fair value
State and municipal securities	\$ 87,521	\$ 5,364	\$ 69	\$ 92,816

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Notes to Consolidated Financial Statements (Unaudited) (Continued)

Market valuations for our investment securities held to maturity are provided by independent third parties. The fair values are determined using several sources for valuing fixed income securities. Their techniques include pricing models that vary based on the type of asset being valued and incorporate available trade, bid and other market information. The market valuation sources provide the significant observable market inputs for these securities and are therefore considered Level 2 inputs for the purpose of determining fair values.

Unrealized losses and fair value for investment securities held to maturity as of September 30, 2016 and December 31, 2015, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, are summarized as follows (in thousands):

	September 30, 2016					
	Less than 12 Months		12 Months or more		Total	
	Fair value	Unrealized loss	Fair value	Unrealized loss	Fair value	Unrealized loss
State and municipal securities	\$ 605	\$ 2	\$ 3,306	\$ 73	\$ 3,911	\$ 75

	December 31, 2015					
	Less than 12 Months		12 Months or more		Total	
	Fair value	Unrealized loss	Fair value	Unrealized loss	Fair value	Unrealized loss
State and municipal securities	\$ 3,573	\$ 24	\$ 2,743	\$ 45	\$ 6,316	\$ 69

For all of the above investment securities, the unrealized losses are generally due to changes in interest rates and continued financial market stress and unrealized losses are considered to be temporary.

We evaluate securities for OTTI on a quarterly basis, at a minimum, and more frequently when economic or market concerns warrant such evaluation. In estimating OTTI losses, we consider the severity and duration of the impairment; the financial condition and near-term prospects of the issuer, which for debt securities considers external credit ratings and recent downgrades; and the intent and ability of the Company to hold the security for a period of time sufficient for a recovery in value.

At September 30, 2016 and December 31, 2015, 17 and 25 held-to-maturity securities, respectively, had unrealized losses with aggregate depreciation of 1.88% and 1.08%, respectively, from their amortized cost basis. The unrealized losses relate principally to the fluctuations in the current interest rate environment. In analyzing an issuer's financial condition, we consider who issued the securities and whether downgrades by bond rating agencies have occurred. As we have the intent and ability to hold debt securities for the foreseeable future, no declines are deemed to be other-than-temporary.

The amortized cost and fair value of held-to-maturity securities as of September 30, 2016, by contractual maturity, are as follows (in thousands):

	Amortized cost	Fair value
Within one year	\$ 1,734	\$ 1,738
After one year through five years	17,166	17,834
After five years through ten years	43,234	47,114
After ten years	20,807	21,904
Total	\$ 82,941	\$ 88,590

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Notes to Consolidated Financial Statements (Unaudited) (Continued)

Note 6 – Loans

The following table presents total loans outstanding by portfolio, which includes Purchased Credit-Impaired (“PCI”) loans, as of September 30, 2016 and December 31, 2015 (in thousands):

	September 30, 2016	December 31, 2015
Loans:		
Commercial	\$ 545,069	\$ 499,573
Commercial real estate	956,298	876,784
Construction and land development	163,900	150,266
Total commercial loans	1,665,267	1,526,623
Residential real estate	216,935	163,224
Consumer	248,131	161,512
Lease financing	182,445	144,230
Total loans	\$ 2,312,778	\$ 1,995,589

Total loans include net deferred loan fees of \$3.5 million and \$5.8 million at September 30, 2016 and December 31, 2015, respectively, and unearned discounts of \$19.7 million and \$15.7 million within the lease financing portfolio at September 30, 2016 and December 31, 2015, respectively.

At September 30, 2016 and December 31, 2015, the Company had commercial and residential loans held for sale totaling \$61.4 million and \$54.4 million, respectively. During the three and nine months ended September 30, 2016, the Company sold commercial and residential real estate loans with proceeds totaling \$450.9 million and \$907.3 million, respectively, and sold commercial and residential real estate loans with proceeds totaling \$299.7 million and \$836.1 million for the comparable periods in 2015, respectively.

The Company monitors and assesses the credit risk of its loan portfolio using the classes set forth below. These classes also represent the segments by which the Company monitors the performance of its loan portfolio and estimates its allowance for loan losses.

Commercial—Loans to varying types of businesses, including municipalities, school districts and nonprofit organizations, for the purpose of supporting working capital, operational needs and term financing of equipment. Repayment of such loans is generally provided through operating cash flows of the business. Commercial loans are predominately secured by equipment, inventory, accounts receivable, and other sources of repayment, although the Company may also secure commercial loans with real estate.

Commercial real estate—Loans secured by real estate occupied by the borrower for ongoing operations, including loans to borrowers engaged in agricultural production, and non-owner occupied real estate leased to one or more tenants, including commercial office, industrial, special purpose, retail and multi-family residential real estate loans.

Construction and land development—Secured loans for the construction of business properties. Real estate construction loans often convert to a real estate commercial loan at the completion of the construction period. Secured development loans are made to borrowers for the purpose of infrastructure improvements to vacant land to create finished marketable residential and commercial lots/land. Most land development loans are originated with the intention that the loans will be paid through the sale of developed lots/land by the developers within twelve months of the completion date. Interest reserves are generally established on real estate construction loans.

Residential real estate—Loans secured by residential properties that in general do not qualify for secondary market sale; however, the risk to return and/or overall relationship are considered acceptable to the Company. This category also includes loans whereby consumers utilize equity in their personal residence, generally through a second mortgage, as collateral to secure the loan.

Consumer—Loans to consumers primarily for the purpose of home improvements, acquiring automobiles, recreational vehicles and boats. These loans consist of relatively small amounts that are spread across many individual borrowers.

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Notes to Consolidated Financial Statements (Unaudited) (Continued)

Lease financing—Indirect financing leases to varying types of businesses for purchases of business equipment. All indirect financing leases require monthly payments, and the weighted average maturity of our leases is less than four years.

Commercial, commercial real estate, construction and land development loans are collectively referred to as the Company's commercial loan portfolio, while residential real estate and consumer loans and lease financing receivables are collectively referred to as the Company's other loan portfolio.

We have extended loans to certain of our directors, executive officers, principal shareholders and their affiliates. These loans were made in the ordinary course of business upon normal terms, including collateralization and interest rates prevailing at the time, and did not involve more than the normal risk of repayment by the borrower. The aggregate loans outstanding to the directors, executive officers, principal shareholders and their affiliates totaled \$21.5 million and \$39.2 million at September 30, 2016 and December 31, 2015, respectively. During the three and nine months ended September 30, 2016, there were \$468,000 and \$10.6 million, respectively, of new loans and other additions, while repayments and other reductions totaled \$2.2 million and \$28.5 million, respectively.

Credit Quality Monitoring

The Company maintains loan policies and credit underwriting standards as part of the process of managing credit risk. These standards include making loans generally within the Company's four main regions, which include eastern, northern and southern Illinois and the St. Louis metropolitan area. Our equipment leasing business, based in Denver, provides financing to business customers across the country.

The Company has a loan approval process involving underwriting and individual and group loan approval authorities to consider credit quality and loss exposure at loan origination. The loans in the Company's commercial loan portfolio are risk rated at origination based on the grading system set forth below. All loan authority is based on the aggregate credit to a borrower and its related entities.

The Company's consumer loan portfolio is primarily comprised of both secured and unsecured loans that are relatively small and are evaluated at origination on a centralized basis against standardized underwriting criteria. The ongoing measurement of credit quality of the consumer loan portfolio is largely done on an exception basis. If payments are made on schedule, as agreed, then no further monitoring is performed. However, if delinquency occurs, the delinquent loans are turned over to the Company's Consumer Collections Group for resolution. Credit quality for the entire consumer loan portfolio is measured by the periodic delinquency rate, nonaccrual amounts and actual losses incurred.

Loans in the commercial loan portfolio tend to be larger and more complex than those in the consumer loan portfolio, and therefore, are subject to more intensive monitoring. All loans in the commercial loan portfolio have an assigned relationship manager, and most borrowers provide periodic financial and operating information that allows the relationship managers to stay abreast of credit quality during the life of the loans. The risk ratings of loans in the commercial loan portfolio are reassessed at least annually, with loans below an acceptable risk rating reassessed more frequently and reviewed by various individuals within the Company at least quarterly.

The Company maintains a centralized independent loan review function that monitors the approval process and ongoing asset quality of the loan portfolio, including the accuracy of loan grades. The Company also maintains an independent appraisal review function that participates in the review of all appraisals obtained by the Company.

Credit Quality Indicators

The Company uses a ten grade risk rating system to monitor the ongoing credit quality of its commercial loan portfolio. These loan grades rank the credit quality of a borrower by measuring liquidity, debt capacity, and coverage and payment behavior as shown in the borrower's financial statements. The risk grades also measure the quality of the borrower's management and the repayment support offered by any guarantors.

The Company considers all loans with Risk Grades of 1 – 6 as acceptable credit risks and structures and manages such relationships accordingly. Periodic financial and operating data combined with regular loan officer interactions are deemed adequate to monitor borrower performance. Loans with Risk Grades of 7 are considered "watch

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Notes to Consolidated Financial Statements (Unaudited) (Continued)

credits” and the frequency of loan officer contact and receipt of financial data is increased to stay abreast of borrower performance. Loans with Risk Grades of 8 – 10 are considered problematic and require special care. Further, loans with Risk Grades of 7 – 10 are managed and monitored regularly through a number of processes, procedures and committees, including oversight by a loan administration committee comprised of executive and senior management of the Company, which includes highly structured reporting of financial and operating data, intensive loan officer intervention and strategies to exit, as well as potential management by the Company’s special assets group. Loans not graded are small loans that are monitored by aging status and payment activity.

The following table presents the recorded investment of commercial loans (excluding PCI loans) by risk category as of September 30, 2016 (in thousands):

	<u>Commercial</u>	<u>Commercial Real Estate</u>	<u>Construction and Land Development</u>	<u>Total</u>
Acceptable credit quality	\$ 518,512	\$ 910,187	\$ 147,490	\$ 1,576,189
Special mention	5,293	9,411	—	14,704
Substandard	11,516	21,072	450	33,038
Substandard – nonaccrual	5,520	6,551	—	12,071
Doubtful	—	—	—	—
Not graded	611	1,610	4,483	6,704
Total (excluding PCI)	<u>\$ 541,452</u>	<u>\$ 948,831</u>	<u>\$ 152,423</u>	<u>\$ 1,642,706</u>

The Company evaluates the credit quality of its other loans based primarily on the aging status of the loan and payment activity. Accordingly, loans on nonaccrual status, any loan past due 90 days or more and still accruing interest, and loans modified under troubled debt restructurings are considered to be impaired for purposes of credit quality evaluation. The following table presents the recorded investment of our other loans (excluding PCI loans) based on the credit risk profile of loans that are performing and loans that are impaired as of September 30, 2016 (in thousands):

	<u>Residential Real Estate</u>	<u>Consumer</u>	<u>Lease Financing</u>	<u>Total</u>
Performing	\$ 205,901	\$ 247,634	\$ 181,718	\$ 635,253
Impaired	4,466	202	727	5,395
Total (excluding PCI)	<u>\$ 210,367</u>	<u>\$ 247,836</u>	<u>\$ 182,445</u>	<u>\$ 640,648</u>

The following table presents the recorded investment of commercial loans (excluding PCI loans) by risk category as of December 31, 2015 (in thousands):

	<u>Commercial</u>	<u>Commercial Real Estate</u>	<u>Construction and Land Development</u>	<u>Total</u>
Acceptable credit quality	\$ 467,355	\$ 821,314	\$ 136,288	\$ 1,424,957
Special mention	16,589	23,737	540	40,866
Substandard	3,448	8,103	—	11,551
Substandard-nonaccrual	5,702	8,844	—	14,546
Doubtful	—	—	—	—
Not graded	351	746	3,379	4,476
Total (excluding PCI)	<u>\$ 493,445</u>	<u>\$ 862,744</u>	<u>\$ 140,207</u>	<u>\$ 1,496,396</u>

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Notes to Consolidated Financial Statements (Unaudited) (Continued)

The following table presents the recorded investment of our other loans (excluding PCI loans) based on the credit risk profile of loans that are performing and loans that are impaired as of December 31, 2015 (in thousands):

	Residential Real Estate	Consumer	Lease Financing	Total
Performing	\$ 151,111	\$ 161,169	\$ 143,832	\$ 456,112
Impaired	4,155	51	398	4,604
Total (excluding PCI)	\$ 155,266	\$ 161,220	\$ 144,230	\$ 460,716

Impaired Loans

Impaired loans include loans on nonaccrual status, any loan past due 90 days or more and still accruing interest and loans modified under troubled debt restructurings. Impaired loans at September 30, 2016 and December 31, 2015 do not include \$29.4 million and \$38.5 million, respectively, of PCI loans. The risk of credit loss on acquired loans was recognized as part of the fair value adjustment at the acquisition date.

A summary of impaired loans (excluding PCI loans) as of September 30, 2016 and December 31, 2015 is as follows (in thousands):

	September 30, 2016	December 31, 2015
Nonaccrual loans:		
Commercial	\$ 5,520	\$ 5,702
Commercial real estate	6,551	8,844
Construction and land development	—	—
Residential real estate	4,063	3,516
Consumer	97	2
Lease financing	727	398
Total nonaccrual loans	16,958	18,462
Accruing loans contractually past due 90 days or more as to interest or principal payments:		
Commercial	351	865
Commercial real estate	—	—
Construction and land development	—	—
Residential real estate	—	228
Consumer	105	49
Lease financing	—	—
Total accruing loans contractually past due 90 days or more as to interest or principal payments	456	1,142
Loans modified under troubled debt restructurings:		
Commercial	648	3
Commercial real estate	11,397	4,873
Construction and land development	64	—
Residential real estate	403	411
Consumer	—	—
Lease financing	—	—
Total loans modified under troubled debt restructurings	12,512	5,287
Total impaired loans (excluding PCI)	\$ 29,926	\$ 24,891

There was no interest income recognized on nonaccrual loans during the three and nine months ended September 30, 2016 and 2015 while the loans were in nonaccrual status. Additional interest income that would have been recorded on nonaccrual loans had they been current in accordance with their original terms was \$243,000 and \$484,000 for the three and nine months ended September 30, 2016, respectively, and \$172,000 and \$741,000 for the comparable periods in 2015, respectively. The Company recognized interest income on loans modified under troubled debt restructurings-commercial and commercial real estate of \$90,000 and \$196,000 for the three and nine months ended September 30, 2016, respectively, and \$104,000 and \$316,000 for the comparable periods in 2015, respectively.

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Notes to Consolidated Financial Statements (Unaudited) (Continued)

The following table presents impaired loans (excluding PCI loans) by portfolio which are individually evaluated as of September 30, 2016 and December 31, 2015, respectively (in thousands):

	September 30, 2016			December 31, 2015		
	Recorded Investment	Unpaid Principal Balance	Related Valuation Allowance	Recorded Investment	Unpaid Principal Balance	Related Valuation Allowance
Impaired loans with a valuation allowance:						
Commercial	\$ 6,119	\$ 9,448	\$ 1,962	\$ 5,789	\$ 8,760	\$ 1,797
Commercial real estate	2,067	2,256	145	9,197	9,489	514
Construction and land development	64	64	6	—	26	—
Residential real estate	3,137	3,750	567	3,206	3,798	626
Consumer	202	113	37	51	52	7
Lease financing	727	727	69	398	398	50
Total impaired loans with a valuation allowance	12,316	16,358	2,786	18,641	22,523	2,994
Impaired loans with no related valuation allowance:						
Commercial	400	445	—	781	781	—
Commercial real estate	15,881	16,107	—	4,520	5,840	—
Construction and land development	—	—	—	—	—	—
Residential real estate	1,329	1,493	—	949	989	—
Consumer	—	91	—	—	—	—
Lease financing	—	—	—	—	—	—
Total impaired loans with no related valuation allowance	17,610	18,136	—	6,250	7,610	—
Total impaired loans:						
Commercial	6,519	9,893	1,962	6,570	9,541	1,797
Commercial real estate	17,948	18,363	145	13,717	15,329	514
Construction and land development	64	64	6	—	26	—
Residential real estate	4,466	5,243	567	4,155	4,787	626
Consumer	202	204	37	51	52	7
Lease financing	727	727	69	398	398	50
Total impaired loans (excluding PCI)	\$ 29,926	\$ 34,494	\$ 2,786	\$ 24,891	\$ 30,133	\$ 2,994

The difference between a loan's recorded investment and the unpaid principal balance represents: (1) a partial charge-off resulting from a confirmed loss due to the value of the collateral securing the loan being below the loan's principal balance and management's assessment that the full collection of the loan balance is not likely and/or (2) payments received on nonaccrual loans that are fully applied to principal on the loan's recorded investment as compared to being applied to principal and interest on the unpaid customer principal and interest balance. The difference between the recorded investment and the unpaid principal balance was \$4.6 million and \$5.2 million at September 30, 2016 and December 31, 2015, respectively.

Midland States Bancorp, Inc.

Notes to Consolidated Financial Statements (Unaudited) (Continued)

The average balance of impaired loans (excluding PCI loans) and interest income recognized on impaired loans during the three months ended September 30, 2016 and 2015 are included in the table below (in thousands):

	Three Months Ended September 30,			
	2016		2015	
	Average Recorded Investment	Interest Income Recognized While on Impaired Status	Average Recorded Investment	Interest Income Recognized While on Impaired Status
Impaired loans with a valuation allowance:				
Commercial	\$ 6,426	\$ 23	\$ 10,972	\$ 3
Commercial real estate	2,170	65	9,475	101
Construction and land development	65	3	9	—
Residential real estate	3,157	13	2,114	12
Consumer	115	—	35	—
Lease financing	727	—	649	—
Total impaired loans with a valuation allowance	<u>12,660</u>	<u>104</u>	<u>23,254</u>	<u>116</u>
Impaired loans with no related valuation allowance:				
Commercial	439	2	383	—
Commercial real estate	15,610	—	4,632	—
Construction and land development	—	—	—	—
Residential real estate	1,341	1	1,364	3
Consumer	91	—	11	—
Lease financing	—	—	—	—
Total impaired loans with no related valuation allowance	<u>17,481</u>	<u>3</u>	<u>6,390</u>	<u>3</u>
Total impaired loans:				
Commercial	6,865	25	11,355	3
Commercial real estate	17,780	65	14,107	101
Construction and land development	65	3	9	—
Residential real estate	4,498	14	3,478	15
Consumer	206	—	46	—
Lease financing	727	—	649	—
Total impaired loans (excluding PCI)	<u>\$ 30,141</u>	<u>\$ 107</u>	<u>\$ 29,644</u>	<u>\$ 119</u>

Midland States Bancorp, Inc.

Notes to Consolidated Financial Statements (Unaudited) (Continued)

The average balance of impaired loans (excluding PCI loans) and interest income recognized on impaired loans during the nine months ended September 30, 2016 and 2015 are included in the table below (in thousands):

	Nine Months Ended September 30,			
	2016		2015	
	Average Recorded Investment	Interest Income Recognized While on Impaired Status	Average Recorded Investment	Interest Income Recognized While on Impaired Status
Impaired loans with a valuation allowance:				
Commercial	\$ 8,115	\$ 24	\$ 12,435	\$ 6
Commercial real estate	2,273	115	9,897	234
Construction and land development	66	6	35	—
Residential real estate	3,234	24	2,163	25
Consumer	118	—	35	—
Lease financing	727	—	649	—
Total impaired loans with a valuation allowance	14,533	169	25,214	265
Impaired loans with no related valuation allowance:				
Commercial	313	1	663	—
Commercial real estate	15,742	56	4,970	76
Construction and land development	—	—	18	—
Residential real estate	1,364	3	1,641	6
Consumer	91	—	42	8
Lease financing	—	—	—	—
Total impaired loans with no related valuation allowance	17,510	60	7,334	90
Total impaired loans:				
Commercial	8,428	25	13,098	6
Commercial real estate	18,015	171	14,867	310
Construction and land development	66	6	53	—
Residential real estate	4,598	27	3,804	31
Consumer	209	—	77	8
Lease financing	727	—	649	—
Total impaired loans (excluding PCI)	\$ 32,043	\$ 229	\$ 32,548	\$ 355

The following table presents the aging status of the recorded investment in loans by portfolio (excluding PCI loans) as of September 30, 2016 (in thousands):

	31-59 Days Past Due	60-89 Days Past Due	Accruing Loans Past Due 90 Days or More	Nonaccrual Loans	Total Past Due	Current	Total Loans
Commercial	\$ 2,974	\$ 2,979	\$ 351	\$ 5,520	\$ 11,824	\$ 529,628	\$ 541,452
Commercial real estate	768	503	—	6,551	7,822	941,009	948,831
Construction and land development	—	22	—	—	22	152,401	152,423
Residential real estate	782	902	—	4,063	5,747	204,620	210,367
Consumer	952	414	105	97	1,568	246,268	247,836
Lease financing	22	—	—	727	749	181,696	182,445
Total (excluding PCI)	\$ 5,498	\$ 4,820	\$ 456	\$ 16,958	\$ 27,732	\$ 2,255,622	\$ 2,283,354

Midland States Bancorp, Inc.

Notes to Consolidated Financial Statements (Unaudited) (Continued)

The following table presents the aging status of the recorded investment in loans by portfolio (excluding PCI loans) as of December 31, 2015 (in thousands):

	31-59 Days Past Due	60-89 Days Past Due	Accruing Loans Past Due 90 Days or More	Nonaccrual Loans	Total Past Due	Current	Total Loans
Commercial	\$ 1,911	\$ 2,296	\$ 865	\$ 5,702	\$ 10,774	\$ 482,671	\$ 493,445
Commercial real estate	288	1,989	—	8,844	11,121	851,623	862,744
Construction and land development	340	—	—	—	340	139,867	140,207
Residential real estate	1,983	438	228	3,516	6,165	149,101	155,266
Consumer	565	273	49	2	889	160,331	161,220
Lease financing	37	—	—	398	435	143,795	144,230
Total (excluding PCI)	<u>\$ 5,124</u>	<u>\$ 4,996</u>	<u>\$ 1,142</u>	<u>\$ 18,462</u>	<u>\$ 29,724</u>	<u>\$ 1,927,388</u>	<u>\$ 1,957,112</u>

Troubled Debt Restructurings

A loan is categorized as a troubled debt restructuring (“TDR”) if a concession is granted to provide for a reduction of either interest or principal due to deterioration in the financial condition of the borrower. TDRs can take the form of a reduction of the stated interest rate, splitting a loan into separate loans with market terms on one loan and concessionary terms on the other loans, receipts of assets from a debtor in partial or full satisfaction of a loan, the extension of the maturity date or dates at a stated interest rate lower than the current market rate for new debt with similar risk, the reduction of the face amount or maturity of the debt as stated in the instrument or other agreement, the reduction of accrued interest or any other concessionary type of renegotiated debt. Loans are not classified as TDRs when the modification is short-term or results in only an insignificant delay or shortfall in the payments to be received.

Loans modified as TDRs for commercial and commercial real estate loans generally consist of allowing commercial borrowers to defer scheduled principal payments and make interest only payments for a specified period of time at the stated interest rate of the original loan agreement or lower payments due to a modification of the loans’ contractual terms. TDRs that continue to accrue interest and are greater than \$50,000 are individually evaluated for impairment, on a quarterly basis, and transferred to nonaccrual status when it is probable that any remaining principal and interest payments due on the loan will not be collected in accordance with the contractual terms of the loan. TDRs that subsequently default are individually evaluated for impairment at the time of default. The allowance for loan losses on TDRs totaled \$191,000 and \$109,000 as of September 30, 2016 and December 31, 2015, respectively. The Company had \$164,000 of unfunded commitments in connection with TDRs at September 30, 2016. The Company had no unfunded commitments in connection with TDRs at December 31, 2015.

The Company’s TDRs are identified on a case-by-case basis in connection with the ongoing loan collection processes. The following table presents TDRs by loan portfolio (excluding PCI loans) as of September 30, 2016 and December 31, 2015 (in thousands):

	September 30, 2016			December 31, 2015		
	Accruing ⁽¹⁾	Non- accrual ⁽²⁾	Total	Accruing ⁽¹⁾	Non- accrual ⁽²⁾	Total
Commercial	\$ 648	\$ 34	\$ 682	\$ 3	\$ 40	\$ 43
Commercial real estate	11,397	5,102	16,499	4,873	5,332	10,205
Construction and land development	64	—	64	—	—	—
Residential real estate	403	335	738	411	383	794
Consumer	—	—	—	—	—	—
Lease financing	—	—	—	—	—	—
Total loans (excluding PCI)	<u>\$ 12,512</u>	<u>\$ 5,471</u>	<u>\$ 17,983</u>	<u>\$ 5,287</u>	<u>\$ 5,755</u>	<u>\$ 11,042</u>

(1) These loans are still accruing interest.

(2) These loans are included in non-accrual loans in the preceding tables.

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Notes to Consolidated Financial Statements (Unaudited) (Continued)

The following table presents a summary of loans by portfolio that were restructured during the three and nine months ended September 30, 2016 and the loans by portfolio that were modified as TDRs within the previous twelve months that subsequently defaulted during the three and nine months ended September 30, 2016 (in thousands):

	Commercial Loan Portfolio			Other Loan Portfolio			Total
	Commercial	Commercial Real Estate	Construction and Land Development	Residential Real Estate	Consumer	Lease Financing	
For the three months ended September 30, 2016:							
<i>Troubled debt restructurings:</i>							
Number of loans	—	2	—	—	—	—	2
Pre-modification outstanding balance	\$ —	\$ 10,207	\$ —	\$ —	\$ —	\$ —	\$ 10,207
Post-modification outstanding balance	—	10,207	—	—	—	—	10,207
<i>Troubled debt restructurings that subsequently defaulted</i>							
Number of loans	—	—	—	—	—	—	—
Recorded balance	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —
For the nine months ended September 30, 2016:							
<i>Troubled debt restructurings:</i>							
Number of loans	3	2	—	—	—	—	5
Pre-modification outstanding balance	\$ 685	\$ 10,207	\$ —	\$ —	\$ —	\$ —	\$ 10,892
Post-modification outstanding balance	647	10,207	—	—	—	—	10,854
<i>Troubled debt restructurings that subsequently defaulted</i>							
Number of loans	—	—	—	—	—	—	—
Recorded balance	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —

The following table presents a summary of loans by portfolio that were restructured during the three and nine months ended September 30, 2015 and the loans by portfolio that were modified as TDRs within the previous twelve months that subsequently defaulted during the three and nine months ended September 30, 2015 (in thousands):

	Commercial Loan Portfolio			Other Loan Portfolio			Total
	Commercial	Commercial Real Estate	Construction and Land Development	Residential Real Estate	Consumer	Lease Financing	
For the three months ended September 30, 2015:							
<i>Troubled debt restructurings:</i>							
Number of loans	1	—	—	—	—	—	1
Pre-modification outstanding balance	\$ 42	\$ —	\$ —	\$ —	\$ —	\$ —	\$ 42
Post-modification outstanding balance	42	—	—	—	—	—	42
<i>Troubled debt restructurings that subsequently defaulted</i>							
Number of loans	—	—	—	—	—	—	—
Recorded balance	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —
For the nine months ended September 30, 2015:							
<i>Troubled debt restructurings:</i>							
Number of loans	1	—	—	—	—	—	1
Pre-modification outstanding balance	\$ 42	\$ —	\$ —	\$ —	\$ —	\$ —	\$ 42
Post-modification outstanding balance	42	—	—	—	—	—	42
<i>Troubled debt restructurings that subsequently defaulted</i>							
Number of loans	—	1	—	—	—	—	1
Recorded balance	\$ —	\$ 71	\$ —	\$ —	\$ —	\$ —	\$ 71

Allowance for Loan Losses

The Company's loan portfolio is principally comprised of commercial, commercial real estate, construction and land development, residential real estate and consumer loans and lease financing receivables. The principal risks to each category of loans are as follows:

Midland States Bancorp, Inc.

Notes to Consolidated Financial Statements (Unaudited) (Continued)

Commercial – The principal risk of commercial loans is that these loans are primarily made based on the identified cash flow of the borrower and secondarily on the collateral underlying the loans. Most often, this collateral consists of accounts receivable, inventory and equipment. Inventory and equipment may depreciate over time, may be difficult to appraise and may fluctuate in value based on the success of the business. If the cash flow from business operations is reduced, the borrower’s ability to repay the loan may be impaired. As such, repayment of such loans is often more sensitive than other types of loans to adverse conditions in the general economy.

Commercial Real Estate – As with commercial loans, repayment of commercial real estate loans is often dependent on the borrowers’ ability to make repayment from the cash flow of the commercial venture. While commercial real estate loans are collateralized by the borrower’s underlying real estate, foreclosure on such assets may be more difficult than with other types of collateralized loans because of the possible effect the foreclosure would have on the borrower’s business, and property values may tend to be partially based upon the value of the business situated on the property.

Construction and Land Development – Construction and land development lending involves additional risks not generally present in other types of lending because funds are advanced upon the estimated future value of the project, which is uncertain prior to its completion and at the time the loan is made, and costs may exceed realizable values in declining real estate markets. Moreover, if the estimate of the value of the completed project proves to be overstated or market values or rental rates decline, the collateral may prove to be inadequate security for the repayment of the loan. Additional funds may also be required to complete the project, and the project may have to be held for an unspecified period of time before a disposition can occur.

Residential Real Estate – The principal risk to residential real estate lending is associated with residential loans not sold into the secondary market. In such cases, given the present state of the residential real estate market, the value of the underlying property may have deteriorated, perhaps rapidly, and the borrower may have little incentive to repay the loan or continue living in the property. Additionally, in areas with high vacancy rates, reselling the property without substantial loss may be difficult.

Consumer – The repayment of consumer loans is typically dependent on the borrower remaining employed through the life of the loan, as well as the possibility that the collateral underlying the loan may not be adequately maintained by the borrower.

Lease Financing Receivables – Our indirect financing leases are primarily for business equipment leased to varying types of small businesses. If the cash flow from business operations is reduced, the businesses ability to repay may become impaired.

Changes in the allowance for loan losses for the three months ended September 30, 2016 and 2015 are as follows (in thousands):

	Three Months Ended September 30,					
	2016			2015		
	Non-PCI Loans	PCI Loans	Total	Non-PCI Loans	PCI Loans	Total
Balance at beginning of period	\$ 13,629	\$ 1,123	\$ 14,752	\$ 14,464	\$ 1,742	\$ 16,206
Provision for loan losses	1,156	236	1,392	6,681	18	6,699
Loan charge-offs	(806)	(58)	(864)	(7,930)	(19)	(7,949)
Loan recoveries	250	29	279	172	29	201
Net loan charge-offs	(556)	(29)	(585)	(7,758)	10	(7,748)
Balance at end of period	<u>\$ 14,229</u>	<u>\$ 1,330</u>	<u>\$ 15,559</u>	<u>\$ 13,387</u>	<u>\$ 1,770</u>	<u>\$ 15,157</u>

Midland States Bancorp, Inc.

Notes to Consolidated Financial Statements (Unaudited) (Continued)

Changes in the allowance for loan losses for the nine months ended September 30, 2016 and 2015 are as follows (in thousands):

	Nine Months Ended September 30,					
	2016			2015		
	Non-PCI Loans	PCI Loans	Total	Non-PCI Loans	PCI Loans	Total
Balance at beginning of period	\$ 14,093	\$ 1,895	\$ 15,988	\$ 10,504	\$ 1,796	\$ 12,300
Provision for loan losses	3,752	(606)	3,146	10,163	(88)	10,075
Loan charge-offs	(4,228)	(58)	(4,286)	(8,914)	(31)	(8,945)
Loan recoveries	612	99	711	1,634	93	1,727
Net loan charge-offs	(3,616)	41	(3,575)	(7,280)	62	(7,218)
Balance at end of period	\$ 14,229	\$ 1,330	\$ 15,559	\$ 13,387	\$ 1,770	\$ 15,157

During the three and nine months ended September 30, 2016, the Company recorded \$806,000 and \$4.2 million, respectively, of non-PCI loan charge-offs. The nine month period amounts included a \$1.6 million charge-off on a nonperforming commercial loan to one borrower and a \$530,000 charge-off on nonperforming commercial loans related to a single credit relationship as a result of the deterioration in the borrower's collateral position on the respective loans during the first quarter of 2016.

The following table represents, by loan portfolio, a summary of changes in the allowance for loan losses for the three and nine months ended September 30, 2016 and 2015 (in thousands):

	Commercial Loan Portfolio			Other Loan Portfolio			Total
	Commercial	Commercial Real Estate	Construction and Land Development	Residential Real Estate	Consumer	Lease Financing	
Changes in allowance for loan losses for the three months ended September 30, 2016:							
Beginning balance	\$ 6,186	\$ 3,511	\$ 569	\$ 2,584	\$ 827	\$ 1,075	\$ 14,752
Provision for loan losses	1,216	(12)	(271)	220	326	(87)	1,392
Charge-offs	(251)	(214)	(1)	(153)	(91)	(154)	(864)
Recoveries	36	129	13	32	20	49	279
Ending balance	\$ 7,187	\$ 3,414	\$ 310	\$ 2,683	\$ 1,082	\$ 883	\$ 15,559
Changes in allowance for loan losses for the three months ended September 30, 2015:							
Beginning balance	\$ 5,488	\$ 7,657	\$ 435	\$ 1,883	\$ 611	\$ 132	\$ 16,206
Provision for loan losses	7,294	(2,097)	48	799	282	373	6,699
Charge-offs	(7,486)	(12)	(23)	(318)	(110)	—	(7,949)
Recoveries	56	57	8	52	25	3	201
Ending balance	\$ 5,352	\$ 5,605	\$ 468	\$ 2,416	\$ 808	\$ 508	\$ 15,157
Changes in allowance for loan losses for the nine months ended September 30, 2016:							
Beginning balance	\$ 6,917	\$ 5,179	\$ 435	\$ 2,120	\$ 749	\$ 588	\$ 15,988
Provision for loan losses	2,619	(1,520)	(154)	886	479	836	3,146
Charge-offs	(2,513)	(461)	(1)	(454)	(225)	(632)	(4,286)
Recoveries	164	216	30	131	79	91	711
Ending balance	\$ 7,187	\$ 3,414	\$ 310	\$ 2,683	\$ 1,082	\$ 883	\$ 15,559
Changes in allowance for loan losses for the nine months ended September 30, 2015:							
Beginning balance	\$ 2,284	\$ 6,925	\$ 486	\$ 2,038	\$ 567	\$ —	\$ 12,300
Provision for loan losses	9,514	(1,316)	(4)	922	386	573	10,075
Charge-offs	(7,587)	(307)	(39)	(665)	(237)	(110)	(8,945)
Recoveries	1,141	303	25	121	92	45	1,727
Ending balance	\$ 5,352	\$ 5,605	\$ 468	\$ 2,416	\$ 808	\$ 508	\$ 15,157

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Notes to Consolidated Financial Statements (Unaudited) (Continued)

The following table represents, by loan portfolio, details regarding the balance in the allowance for loan losses and the recorded investment in loans as of September 30, 2016 and December 31, 2015 by impairment evaluation method (in thousands):

	Commercial Loan Portfolio			Other Loan Portfolio			Total
	Commercial	Commercial Real Estate	Construction and Land Development	Residential Real Estate	Consumer	Lease Financing	
September 30, 2016:							
Allowance for loan losses:							
Loans individually evaluated for impairment	\$ 1,950	\$ 118	\$ 6	\$ 359	\$ 14	\$ 5	\$ 2,452
Loans collectively evaluated for impairment	12	27	—	207	23	65	334
Non-impaired loans collectively evaluated for impairment	4,569	3,041	304	1,694	1,022	813	11,443
Loans acquired with deteriorated credit quality ⁽¹⁾	656	228	—	423	23	—	1,330
Total allowance for loan losses	\$ 7,187	\$ 3,414	\$ 310	\$ 2,683	\$ 1,082	\$ 883	\$ 15,559
Recorded investment (loan balance):							
Impaired loans individually evaluated for impairment	\$ 6,423	\$ 17,728	\$ 64	\$ 2,752	\$ 14	\$ 198	\$ 27,179
Impaired loans collectively evaluated for impairment	96	220	—	1,714	188	529	2,747
Non-impaired loans collectively evaluated for impairment	534,933	930,883	152,359	205,901	247,634	181,718	2,253,428
Loans acquired with deteriorated credit quality ⁽¹⁾	3,617	7,467	11,477	6,568	295	—	29,424
Total recorded investment (loan balance)	\$ 545,069	\$ 956,298	\$ 163,900	\$ 216,935	\$ 248,131	\$ 182,445	\$ 2,312,778
December 31, 2015:							
Allowance for loan losses:							
Loans individually evaluated for impairment	\$ 1,765	\$ 479	\$ —	\$ 452	\$ —	\$ —	\$ 2,696
Loans collectively evaluated for impairment	32	35	—	174	7	50	298
Non-impaired loans collectively evaluated for impairment	4,745	3,662	419	1,000	735	538	11,099
Loans acquired with deteriorated credit quality ⁽¹⁾	375	1,003	16	494	7	—	1,895
Total allowance for loan losses	\$ 6,917	\$ 5,179	\$ 435	\$ 2,120	\$ 749	\$ 588	\$ 15,988
Recorded investment (loan balance):							
Impaired loans individually evaluated for impairment	\$ 6,316	\$ 13,434	\$ —	\$ 2,778	\$ —	\$ —	\$ 22,528
Impaired loans collectively evaluated for impairment	254	283	—	1,377	51	398	2,363
Non-impaired loans collectively evaluated for impairment	486,875	849,027	140,207	151,111	161,169	143,832	1,932,221
Loans acquired with deteriorated credit quality ⁽¹⁾	6,128	14,040	10,059	7,958	292	—	38,477
Total recorded investment (loan balance)	\$ 499,573	\$ 876,784	\$ 150,266	\$ 163,224	\$ 161,512	\$ 144,230	\$ 1,995,589

(1) Loans acquired with deteriorated credit quality were originally recorded at fair value at the acquisition date and the risk of credit loss was recognized at that date based on estimates of expected cash flows.

Purchased Credit Impaired Loans

Purchased loans acquired in a business combination, including loans purchased in our FDIC-assisted transactions, are recorded at estimated fair value on their purchase date without a carryover of the related allowance for loan losses. PCI loans are loans that have evidence of credit deterioration since origination, and it is probable at the date of acquisition that the Company will not collect all contractually required principal and interest payments. Evidence of credit quality deterioration as of the purchase date may include factors such as past due and nonaccrual status. The difference between contractually required principal and interest at acquisition and the cash flows expected to be collected at acquisition is referred to as the non-accretable difference. Subsequent decreases to the expected cash flows will generally result in impairment, which is recorded as provision for loan losses in the consolidated statements of income. Subsequent increases in cash flows result in a reversal of the provision for loan losses to the extent of prior charges or a reclassification of the difference from non-accretable to accretable with a positive impact on interest income. Further, any excess cash flows expected at acquisition over the estimated fair value is referred to as the accretable yield and is recognized into interest income over the remaining life of the loan when there is a reasonable expectation about the amount and timing of such cash flows.

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Notes to Consolidated Financial Statements (Unaudited) (Continued)

Changes in the accretible yield for PCI loans were as follows for the three and nine months ended September 30, 2016 and 2015 (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Balance at beginning of period	\$ 6,729	\$ 14,237	\$ 10,526	\$ 16,198
Accretion	(1,810)	(1,006)	(7,066)	(3,013)
Other adjustments (including maturities, charge-offs and impact of changes in timing of expected cash flows)	179	—	(96)	67
Reclassification from non-accretible	2,568	325	4,302	304
Balance at end of period	<u>\$ 7,666</u>	<u>\$ 13,556</u>	<u>\$ 7,666</u>	<u>\$ 13,556</u>

The fair value of PCI loans, on the acquisition date, was determined based on assigned risk ratings, expected cash flows and the fair value of loan collateral.

The carrying amount of covered loans and non-covered loans as of September 30, 2016 and December 31, 2015 consisted of PCI loans and non-PCI loans as shown in the following table (in thousands):

	September 30, 2016			December 31, 2015		
	Non-PCI Loans	PCI Loans	Total	Non-PCI Loans	PCI Loans	Total
Covered loans: ⁽¹⁾						
Commercial	\$ —	\$ —	\$ —	\$ 378	\$ 1,067	\$ 1,445
Commercial real estate	—	—	—	876	318	1,194
Construction and land development	—	—	—	—	—	—
Residential real estate	688	98	786	715	275	990
Consumer	—	—	—	—	—	—
Lease financing	—	—	—	—	—	—
Total covered loans	<u>688</u>	<u>98</u>	<u>786</u>	<u>1,969</u>	<u>1,660</u>	<u>3,629</u>
Non-covered loans:						
Commercial	541,452	3,617	545,069	493,067	5,061	498,128
Commercial real estate	948,831	7,467	956,298	861,868	13,722	875,590
Construction and land development	152,423	11,477	163,900	140,207	10,059	150,266
Residential real estate	209,679	6,470	216,149	154,551	7,683	162,234
Consumer	247,836	295	248,131	161,220	292	161,512
Lease financing	182,445	—	182,445	144,230	—	144,230
Total non-covered loans	<u>2,282,666</u>	<u>29,326</u>	<u>2,311,992</u>	<u>1,955,143</u>	<u>36,817</u>	<u>1,991,960</u>
Total loans	<u>\$ 2,283,354</u>	<u>\$ 29,424</u>	<u>\$ 2,312,778</u>	<u>\$ 1,957,112</u>	<u>\$ 38,477</u>	<u>\$ 1,995,589</u>

(1) Covered loans include loans from our 2010 acquisition. On October 3, 2016, the Company entered into an agreement with the FDIC to terminate its existing loss share agreements as more fully described in Note 21 to the Consolidated Financial Statements.

The outstanding customer balance for PCI loans totaled \$37.1 million and \$44.5 million as of September 30, 2016 and December 31, 2015, respectively.

Note 7 – Mortgage Servicing Rights

At September 30, 2016 and December 31, 2015, the Company serviced mortgage loans for others totaling \$5.63 billion and \$5.48 billion, respectively. A summary of mortgage loans serviced for others as of September 30, 2016 and December 31, 2015 is as follows (in thousands):

	September 30, 2016	December 31, 2015
Commercial FHA mortgage loans	\$ 3,806,872	\$ 3,649,524
Residential mortgage loans	1,821,151	1,826,280
Total loans serviced for others	<u>\$ 5,628,023</u>	<u>\$ 5,475,804</u>

Midland States Bancorp, Inc.

Notes to Consolidated Financial Statements (Unaudited) (Continued)

Changes in our mortgage servicing rights were as follows for the three and nine months ended September 30, 2016 and 2015 (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Mortgage servicing rights:				
Balance at beginning of period	\$ 68,395	\$ 64,921	\$ 67,218	\$ 62,900
Servicing rights capitalized – commercial FHA mortgage loans	3,506	1,411	5,777	2,866
Servicing rights capitalized – residential mortgage loans	1,125	1,105	2,764	4,185
Amortization – commercial FHA mortgage loans	(592)	(552)	(1,741)	(1,708)
Amortization – residential mortgage loans	(1,085)	(673)	(2,669)	(2,031)
Balance at end of period	<u>71,349</u>	<u>66,212</u>	<u>71,349</u>	<u>66,212</u>
Valuation allowances:				
Balance at beginning of period	5,587	—	567	119
Additions	1,073	795	6,301	1,630
Reductions	—	—	(208)	(954)
Balance at end of period	<u>6,660</u>	<u>795</u>	<u>6,660</u>	<u>795</u>
Mortgage servicing rights, net	<u>\$ 64,689</u>	<u>\$ 65,417</u>	<u>\$ 64,689</u>	<u>\$ 65,417</u>
Fair value:				
At beginning of period	\$ 62,960	\$ 66,442	\$ 66,700	\$ 62,781
At end of period	<u>\$ 64,689</u>	<u>\$ 66,074</u>	<u>\$ 64,689</u>	<u>\$ 66,074</u>

The following table is a summary of key assumptions, representing both general economic and other published information and the weighted average characteristics of the commercial and residential portfolios, used in the valuation of servicing rights at September 30, 2016 and December 31, 2015. Assumptions used in the prepayment rate consider many factors as appropriate, including lockouts, balloons, prepayment penalties, interest rate ranges, delinquencies and geographic location. The discount rate is based on an average pre-tax internal rate of return utilized by market participants in pricing the servicing portfolios. Significant increases or decreases in any one of these assumptions would result in a significantly lower or higher fair value measurement.

	Servicing Fee	Interest Rate	Remaining Years to Maturity	Prepayment Rate	Servicing Cost	Discount Rate
September 30, 2016:						
Commercial FHA mortgage loans	0.13 %	3.75 %	30.3	8.33 %	\$ 1,000	10 - 13 %
Residential mortgage loans	0.27 %	3.93 %	24.2	18.42 %	\$ 73.46	9 - 11 %
December 31, 2015:						
Commercial FHA mortgage loans	0.12 %	3.85 %	30.6	8.53 %	\$ 1,000	10 - 13 %
Residential mortgage loans	0.27 %	3.96 %	24.4	11.22 %	\$ 73.66	9 - 11 %

We recognize revenue from servicing commercial FHA and residential mortgages as earned based on the specific contractual terms. This revenue, along with amortization of and changes in impairment on servicing rights, is reported in commercial FHA revenue and residential mortgage banking revenue in the consolidated statements of income. Mortgage servicing rights do not trade in an active market with readily observable prices. The fair value of mortgage servicing rights and their sensitivity to changes in interest rates is influenced by the mix of the servicing portfolio and characteristics of each segment of the portfolio. The Company's servicing portfolio consists of the distinct portfolios of government-insured residential and commercial mortgages and conventional residential mortgages. The fair value of our servicing rights is estimated by using a cash flow valuation model which calculates the present value of estimated future net servicing cash flows, taking into consideration expected mortgage loan prepayment rates, discount rates, cost to service, contractual servicing fee income, ancillary income, late fees, replacement reserves and other economic factors that are determined based on current market conditions.

Midland States Bancorp, Inc.

Notes to Consolidated Financial Statements (Unaudited) (Continued)

Note 8 – Intangible Assets

The Company's intangible assets, consisting of core deposit and trust relationship intangibles, as of September 30, 2016 and December 31, 2015 are summarized as follows (in thousands):

	September 30, 2016			December 31, 2015		
	Gross Carrying Amount	Accumulated Amortization	Total	Gross Carrying Amount	Accumulated Amortization	Total
Core deposit intangibles	\$ 20,542	\$ (15,770)	\$ 4,772	\$ 20,542	\$ (14,471)	\$ 6,071
Customer relationship intangibles	3,141	(2,522)	619	3,141	(2,208)	933
Total intangible assets	\$ 23,683	\$ (18,292)	\$ 5,391	\$ 23,683	\$ (16,679)	\$ 7,004

Amortization of intangible assets was \$514,000 and \$1.6 million for the three and nine months ended September 30, 2016, respectively, and \$597,000 and \$1.9 million for the comparable periods in 2015, respectively.

Note 9 – Derivative Instruments

As part of the Company's overall management of interest rate sensitivity, the Company utilizes derivative instruments to minimize significant, unanticipated earnings fluctuations caused by interest rate volatility, including interest rate lock commitments, forward commitments to sell mortgage-backed securities and interest rate swap agreements.

Interest Rate Lock Commitments / Forward Commitments to Sell Mortgage-Backed Securities

Derivative instruments issued by the Company consist of interest rate lock commitments to originate fixed-rate loans to be sold. Commitments to originate fixed-rate loans consist of commercial and residential real estate loans. The interest rate lock commitments and loans held for sale are hedged with forward contracts to sell mortgage-backed securities. The fair value of the interest rate lock commitments and forward contracts to sell mortgage-backed securities are included in other assets or other liabilities in the consolidated balance sheets. Changes in the fair value of derivative financial instruments are recognized in commercial FHA revenue and residential mortgage banking revenue in the consolidated statements of income.

The following table summarizes the interest rate lock commitments and forward commitments to sell mortgage-backed securities held by the Company, their notional amount, estimated fair values and the location in which the derivative instruments are reported in the consolidated balances sheets at September 30, 2016 and December 31, 2015 (in thousands):

	Notional Amount		Fair Value Gain	
	September 30, 2016	December 31, 2015	September 30, 2016	December 31, 2015
Derivative Instruments (included in Other Assets):				
Interest rate lock commitments	\$ 294,010	\$ 257,023	\$ 6,798	\$ 6,029
	Notional Amount		Fair Value Loss	
	September 30, 2016	December 31, 2015	September 30, 2016	December 31, 2015
Derivative Instruments (included in Other Liabilities):				
Forward commitments to sell mortgage-backed securities	\$ 323,103	\$ 278,313	\$ 244	\$ 2

Net losses recognized on derivative instruments were \$5.2 million for the three months ended September 30, 2016 and net gains recognized on derivative instruments were \$527,000 for the nine months ended September 30, 2016. Net gains of \$272,000 and \$6.3 million were recognized on derivative instruments for the three and nine months ended September 30, 2015, respectively. Net gains and losses on derivative instruments were recognized in commercial FHA revenue and residential mortgage banking revenue in the consolidated statements of income.

Interest Rate Swap Agreements

In August 2011, the Company entered into an interest rate swap agreement to convert its variable rate trust preferred debentures to a fixed rate. The agreement commenced on August 15, 2012 at a notional amount of \$10.0

Midland States Bancorp, Inc.

Notes to Consolidated Financial Statements (Unaudited) (Continued)

million and matured on October 15, 2016. Under the agreement, the Company received interest at a variable rate equal to 2.75% over the three-month LIBOR and paid interest at a fixed rate of 4.66%. As of September 30, 2016 and December 31, 2015, the fair value of the agreement reflected losses of \$32,000 and \$126,000, respectively, which were included in other liabilities in the consolidated balance sheets.

Note 10 – Deposits

The following table summarizes the classification of deposits as of September 30, 2016 and December 31, 2015 (in thousands):

	September 30, 2016	December 31, 2015
Noninterest-bearing demand	\$ 629,113	\$ 543,401
Interest-bearing:		
NOW	658,021	621,925
Money market	366,193	377,654
Savings	162,742	155,778
Time	603,963	668,890
Total deposits	<u>\$ 2,420,032</u>	<u>\$ 2,367,648</u>

Note 11 – Short-Term Borrowings

The following table presents the distribution of short-term borrowings and related weighted average interest rates as of and for the nine months ended September 30, 2016 and as of and for the year ended December 31, 2015 (in thousands):

	Repurchase Agreements	
	September 30, 2016	December 31, 2015
Outstanding at period-end	\$ 138,289	\$ 107,538
Average amount outstanding	123,191	123,447
Maximum amount outstanding at any month end	138,289	147,542
Weighted average interest rate:		
During period	0.24 %	0.19 %
End of period	0.23 %	0.21 %

At September 30, 2016, the Bank had federal funds lines of credit totaling \$68.0 million. These lines of credit were unused at September 30, 2016.

Securities sold under agreements to repurchase, which are classified as secured borrowings, generally mature within one to four days from the transaction date. Securities sold under agreements to repurchase are reflected at the amount of cash received in connection with the transaction, which represents the amount of the Bank's obligation. The Bank may be required to provide additional collateral based on the fair value of the underlying securities. Investment securities with a carrying amount of \$145.7 million and \$113.4 million at September 30, 2016 and December 31, 2015, respectively, were pledged for securities sold under agreements to repurchase.

The Bank had lines of credit of \$39.6 million and \$62.1 million at September 30, 2016 and December 31, 2015, respectively, from the Federal Reserve Discount Window. The lines are collateralized by a collateral agreement with respect to a pool of commercial real estate loans totaling \$47.6 million and \$76.7 million at September 30, 2016 and December 31, 2015, respectively. There were no outstanding advances at September 30, 2016 and December 31, 2015.

Midland States Bancorp, Inc.

Notes to Consolidated Financial Statements (Unaudited) (Continued)

Note 12 – FHLB Advances and Other Borrowings

The following table summarizes our Federal Home Loan Bank (“FHLB”) advances and other borrowings as of September 30, 2016 and December 31, 2015 (in thousands):

	September 30, 2016	December 31, 2015
FHLB advances – fixed rate, fixed term, at rates averaging 0.66% and 0.93%, respectively, at September 30, 2016 and December 31, 2015 – maturing through May 2023	\$ 237,500	\$ 40,000
Obligations under capital leases – implicit interest rate of 1.70% – maturing through July 2018	43	178
Total FHLB advances and other borrowings	<u>\$ 237,543</u>	<u>\$ 40,178</u>

The Company’s advances from the FHLB are collateralized by a blanket collateral agreement of qualifying mortgage and home equity line of credit loans and certain commercial loans totaling approximately \$1.15 billion and \$987.4 million at September 30, 2016 and December 31, 2015, respectively.

Note 13 – Subordinated Debt

The following table summarizes the Company’s subordinated debt as of September 30, 2016 and December 31, 2015 (in thousands):

	September 30, 2016	December 31, 2015
Subordinated debt issued June 2013 – fixed interest rate of 8.25%, \$8,000 maturing June 28, 2021	\$ —	\$ 7,448
Subordinated debt issued June 2015 – fixed interest rate of 6.00% for the first five years through June 2020 and a variable interest rate equivalent to three month LIBOR plus 4.35% thereafter, \$40,325 maturing June 18, 2025	39,712	39,659
Subordinated debt issued June 2015 – fixed interest rate of 6.50%, \$15,000 maturing June 18, 2025	14,772	14,752
Total subordinated debt	<u>\$ 54,484</u>	<u>\$ 61,859</u>

In June 2015, the Company issued \$55.3 million of subordinated debt in a private placement. The transaction was structured in two tranches: (1) \$40.3 million, maturing on June 18, 2025 with a redemption option on or after June 18, 2020, with a fixed rate of interest of 6.00% for the first five years, payable semiannually in arrears beginning December 18, 2015, and a floating rate of interest equivalent to the three-month LIBOR plus 435 basis points thereafter, payable quarterly beginning on September 18, 2020; and (2) \$15.0 million, maturing on June 18, 2025, with a fixed rate of interest of 6.50%, payable semiannually in arrears beginning December 18, 2015. The value of the subordinated debentures was reduced by \$0.9 million with the recording of debt issuance costs associated with the issuance of the subordinated debentures, which are being amortized on a straight line basis through maturity of the subordinated notes.

On January 2, 2013, a third party committed to invest a total of \$10.0 million in the Company in the form of \$8.0 million of subordinated notes and \$2.0 million of common stock. On March 26, 2013, we issued 125,000 shares of common stock pursuant to the terms of the commitment. In addition, 8.25% subordinated notes totaling \$8.0 million were issued on June 28, 2013 with a maturity date of June 28, 2021. An 8-year detachable warrant for the purchase of 125,000 shares at \$16.00 per share of common stock of the Company was issued concurrently with the funding of the notes. The detachable warrants became exercisable one year after issuance. The detachable warrants were valued at \$0.6 million and recorded on a relative value basis separately in shareholders’ equity. Correspondingly, the value of the subordinated notes was reduced by \$0.6 million with the recording of a discount that the Company was amortizing using the interest method over the life of the subordinated notes. On June 28, 2016, the Company repaid the \$8.0 million subordinated debt issued in June 2013 and recognized the remaining discount of \$0.5 million in other noninterest expense in the consolidated statements of income.

The subordinated debentures may be included in Tier 1 capital (with certain limitations applicable) under current regulatory guidelines and interpretations.

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Notes to Consolidated Financial Statements (Unaudited) (Continued)

Note 14 – Trust Preferred Debentures

The following table summarizes the Company’s trust preferred debentures as of September 30, 2016 and December 31, 2015 (in thousands):

	September 30, 2016	December 31, 2015
Grant Park Statutory Trust I – variable interest rate equal to LIBOR plus 2.85%, which was 3.61% and 3.17%, at September 30, 2016 and December 31, 2015, respectively – \$3,000 maturing January 23, 2034	\$ 1,980	\$ 1,932
Midland States Preferred Securities Trust – variable interest rate equal to LIBOR plus 2.75%, which was 3.46% and 3.07% at September 30, 2016 and December 31, 2015, respectively – \$10,000 maturing April 23, 2034	9,956	9,954
LSHC Capital Trust III – variable interest rate equal to LIBOR plus 1.75%, which was 2.60% and 2.26% at September 30, 2016 and December 31, 2015, respectively – \$20,000 maturing December 31, 2036	13,105	13,001
LSHC Capital Trust IV – variable interest rate equal to LIBOR plus 1.47%, which was 2.31% and 1.92% at September 30, 2016 and December 31, 2015, respectively – \$20,000 maturing September 6, 2037	12,275	12,170
Total trust preferred debentures	<u>\$ 37,316</u>	<u>\$ 37,057</u>

Note 15 – Earnings Per Share

Earnings per share are calculated utilizing the two-class method. Basic earnings per share are calculated by dividing the sum of distributed earnings to common shareholders and undistributed earnings allocated to common shareholders by the weighted average number of common shares outstanding. Diluted earnings per share are calculated by dividing the sum of distributed earnings to common shareholders and undistributed earnings allocated to common shareholders by the weighted average number of shares adjusted for the dilutive effect of common stock awards using the treasury stock method (outstanding stock options and unvested restricted stock), convertible preferred stock and convertible subordinated debt. Presented below are the calculations for basic and diluted earnings per common share for the three and nine months ended September 30, 2016 and 2015 (in thousands, except for share and per share data):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Net income	\$ 8,051	\$ 3,445	\$ 19,959	\$ 16,629
Common shareholder dividends	(2,773)	(1,881)	(7,022)	(5,643)
Unvested restricted stock award dividends	(12)	(12)	(35)	(37)
Undistributed earnings to unvested restricted stock awards	(26)	(10)	(69)	(71)
Undistributed earnings to common shareholders	<u>\$ 5,240</u>	<u>\$ 1,542</u>	<u>\$ 12,833</u>	<u>\$ 10,878</u>
Basic				
Distributed earnings to common shareholders	\$ 2,773	\$ 1,881	\$ 7,022	\$ 5,643
Undistributed earnings to common shareholders	5,240	1,542	12,833	10,878
Total common shareholders earnings, basic	<u>\$ 8,013</u>	<u>\$ 3,423</u>	<u>\$ 19,855</u>	<u>\$ 16,521</u>
Diluted				
Distributed earnings to common shareholders	\$ 2,773	\$ 1,881	\$ 7,022	\$ 5,643
Undistributed earnings to common shareholders	5,240	1,542	12,833	10,878
Total common shareholders earnings	8,013	3,423	19,855	16,521
Add back:				
Undistributed earnings reallocated from unvested restricted stock awards	—	—	1	1
Total common shareholders earnings, diluted	<u>\$ 8,013</u>	<u>\$ 3,423</u>	<u>\$ 19,856</u>	<u>\$ 16,522</u>
Weighted average common shares outstanding, basic	15,578,703	11,911,414	13,637,997	11,895,337
Options and warrants	279,570	219,115	264,667	216,358
Weighted average common shares outstanding, diluted	<u>15,858,273</u>	<u>12,130,529</u>	<u>13,902,664</u>	<u>12,111,695</u>
Basic earnings per common share	\$ 0.51	\$ 0.29	\$ 1.46	\$ 1.39
Diluted earnings per common share	0.51	0.28	1.43	1.36

Midland States Bancorp, Inc.

Notes to Consolidated Financial Statements (Unaudited) (Continued)

Note 16 – Capital Requirements

Our primary source of cash is dividends received from the Bank. The Bank is restricted by Illinois law and regulations of the Illinois Department of Financial and Professional Regulation and the FDIC as to the maximum amount of dividends the Bank can pay to us. As a practical matter, the Bank restricts dividends to a lesser amount because of the need to maintain an adequate capital structure.

We are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and additional discretionary actions by regulators that, if undertaken, could have a direct material effect on our consolidated financial statements. The regulators require the Company to meet specific capital adequacy guidelines that involve quantitative measures of the Bank's assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. Our capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Company and the Bank to maintain minimum amounts and ratios of Total capital, Tier 1 capital and common equity Tier 1 capital to risk-weighted assets (as defined in the regulations), and of Tier 1 capital to average assets (as defined in the regulations).

In July 2013, the federal bank regulators approved final rules implementing the Basel Committee on Banking Supervision's capital adequacy guidelines (the "Basel III Rules"), as well as certain provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), which were effective January 1, 2015. Under the Basel III Rules, minimum requirements increased for both the quantity and quality of capital held by the Company. The rules included a new common equity Tier 1 capital to risk-weighted assets minimum ratio of 4.5%, raised the minimum ratio of Tier 1 capital to risk-weighted assets from 4.0% to 6.0%, require a minimum ratio of Total capital to risk-weighted assets of 8.0%, and require a minimum Tier 1 leverage ratio of 4.0%. The Basel III Rules also established a new capital conservation buffer, comprised of common equity Tier 1 capital, which is 0.625% beginning January 1, 2016 and will increase by 0.625% each subsequent year until it reaches its final level of 2.5% on January 1, 2019.

The minimum required ratios under the Basel III Rules for well-capitalized banks (under prompt corrective action provisions) are 6.5% for Tier 1 common equity, 8.0% for Tier 1 capital, 10.0% for Total capital and 5.0% for Tier 1 leverage capital. These thresholds were effective January 1, 2015.

As of September 30, 2016, the Company and the Bank met all capital adequacy requirements to which they are subject, and the Bank's capital position exceeded the regulatory definition of well-capitalized.

Midland States Bancorp, Inc.

Notes to Consolidated Financial Statements (Unaudited) (Continued)

At September 30, 2016 and December 31, 2015, the Company's and the Bank's actual and required capital ratios were as follows (in thousands, except for ratios):

	September 30, 2016					
	Actual		Minimum Required For Capital Adequacy Purposes		Required to be Well Capitalized Under Prompt Corrective Action Requirements	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
Total capital (to risk-weighted assets):						
Midland States Bancorp, Inc.	\$ 366,333	13.53 %	\$ 216,588	8.00 %	N/A	N/A
Midland States Bank	317,823	11.72	216,957	8.00	\$ 271,196	10.00 %
Tier 1 capital (to risk-weighted assets):						
Midland States Bancorp, Inc.	296,148	10.94 %	162,441	6.00 %	N/A	N/A
Midland States Bank	302,122	11.14	162,718	6.00	216,957	8.00 %
Common equity Tier 1 capital (to risk-weighted assets):						
Midland States Bancorp, Inc.	244,378	9.03 %	121,831	4.50 %	N/A	N/A
Midland States Bank	302,122	11.14	122,038	4.50	176,277	6.50 %
Tier 1 leverage (to average assets):						
Midland States Bancorp, Inc.	296,148	9.82 %	120,688	4.00 %	N/A	N/A
Midland States Bank	302,122	10.00	120,794	4.00	150,993	5.00 %
	December 31, 2015					
	Actual		Minimum Required For Capital Adequacy Purposes		Required to be Well Capitalized Under Prompt Corrective Action Requirements	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
Total capital (to risk-weighted assets):						
Midland States Bancorp, Inc.	\$ 288,958	11.82 %	\$ 195,550	8.00 %	N/A	N/A
Midland States Bank	270,436	11.06	195,702	8.00	\$ 244,628	10.00 %
Tier 1 capital (to risk-weighted assets):						
Midland States Bancorp, Inc.	210,614	8.62 %	146,662	6.00 %	N/A	N/A
Midland States Bank	254,228	10.39	146,777	6.00	195,702	8.00 %
Common equity Tier 1 capital (to risk-weighted assets):						
Midland States Bancorp, Inc.	158,969	6.50 %	109,997	4.50 %	N/A	N/A
Midland States Bank	254,228	10.39	110,082	4.50	159,008	6.50 %
Tier 1 leverage (to average assets):						
Midland States Bancorp, Inc.	210,614	7.49 %	112,500	4.00 %	N/A	N/A
Midland States Bank	254,228	9.01	112,827	4.00	141,034	5.00 %

Midland States Bancorp, Inc.

Notes to Consolidated Financial Statements (Unaudited) (Continued)

Note 17 – Fair Value of Financial Instruments

ASC 820, *Fair Value Measurements*, defines fair value, establishes a framework for measuring fair value including a three-level valuation hierarchy, and expands disclosures about fair value measurements. Fair value is defined as the exchange price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date reflecting assumptions that a market participant would use when pricing an asset or liability. The hierarchy uses three levels of inputs to measure the fair value of assets and liabilities as follows:

- Level 1: Unadjusted quoted prices for identical assets or liabilities traded in active markets.
- Level 2: Observable inputs other than Level 1, including quoted prices for similar assets and liabilities in active markets, quoted prices in less active markets, or other observable inputs that can be corroborated by observable market data, either directly or indirectly, for substantially the full term of the financial instrument.
- Level 3: Inputs to a valuation methodology that are unobservable, supported by little or no market activity, and significant to the fair value measurement. These valuation methodologies generally include pricing models, discounted cash flow models, or a determination of fair value that requires significant management judgment or estimation. This category also includes observable inputs from a pricing service not corroborated by observable market data, such as pricing non-agency mortgage backed securities.

Fair value is used on a recurring basis to account for securities available for sale and derivative instruments, and for financial assets for which the Company has elected the fair value option. For assets and liabilities measured at the lower of cost or fair value, the fair value measurement criteria may or may not be met during a reporting period and such measurements are therefore considered “nonrecurring” for purposes of disclosing our fair value measurements. Fair value is used on a nonrecurring basis to adjust carrying values for impaired loans and other real estate owned and also to record impairment on certain assets, such as goodwill, core deposit intangibles and other long-lived assets.

Assets and liabilities measured and recorded at fair value, including financial assets for which the Company has elected the fair value option, on a recurring and nonrecurring basis as of September 30, 2016 and December 31, 2015, are summarized below (in thousands):

	September 30, 2016			
	Total	Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Assets and liabilities measured at fair value on a recurring basis:				
Assets				
Securities available for sale:				
U.S. Treasury securities	\$ 35,506	\$ 35,506	\$ —	\$ —
Government sponsored entity debt securities	8,990	—	8,990	—
Agency mortgage-backed securities	68,656	—	68,656	—
Non-agency mortgage-backed securities	1	—	—	1
Covered non-agency mortgage-backed securities	72,093	—	72,093	—
State and municipal securities	21,980	—	21,980	—
Corporate securities	44,986	—	37,506	7,480
Loans held for sale	61,363	—	61,363	—
Interest rate lock commitments	6,798	—	6,798	—
Total	<u>\$ 320,373</u>	<u>\$ 35,506</u>	<u>\$ 277,386</u>	<u>\$ 7,481</u>
Liabilities				
Interest rate swap agreement	\$ 32	\$ —	\$ 32	\$ —
Forward commitments to sell mortgage-backed securities	244	—	244	—
Total	<u>\$ 276</u>	<u>\$ —</u>	<u>\$ 276</u>	<u>\$ —</u>
Assets measured at fair value on a non-recurring basis:				
Impaired loans	\$ 10,542	\$ —	\$ 3,081	\$ 7,461
Other real estate owned	915	—	915	—

Midland States Bancorp, Inc.

Notes to Consolidated Financial Statements (Unaudited) (Continued)

	December 31, 2015			
	Total	Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Assets and liabilities measured at fair value on a recurring basis:				
Assets				
Securities available for sale:				
U.S. Treasury securities	\$ 48,302	\$ 48,302	\$ —	\$ —
Government sponsored entity debt securities	9,454	—	9,454	—
Agency mortgage-backed securities	67,527	—	67,527	—
Non-agency mortgage-backed securities	2	—	2	—
Covered non-agency mortgage-backed securities	75,979	—	75,979	—
State and municipal securities	15,494	—	15,494	—
Corporate securities	19,869	—	19,869	—
Loans held for sale	54,413	—	54,413	—
Interest rate lock commitments	6,029	—	6,029	—
Total	\$ 297,069	\$ 48,302	\$ 248,767	\$ —
Liabilities				
Interest rate swap agreement	\$ 126	\$ —	\$ 126	\$ —
Forward commitments to sell mortgage-backed securities	2	—	2	—
Contingent consideration	350	—	—	350
Total	\$ 478	\$ —	\$ 128	\$ 350
Assets measured at fair value on a non-recurring basis:				
Impaired loans	\$ 16,667	\$ —	\$ 8,821	\$ 7,846
Other real estate owned	535	—	535	—

The following table presents losses recognized on assets measured on a non-recurring basis for the three and nine months ended September 30, 2016 and 2015 (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Impaired loans	\$ 144	\$ 1,755	\$ 310	\$ 1,755
Other real estate owned	4	—	219	49
Total loss on assets measured on a nonrecurring basis	\$ 148	\$ 1,755	\$ 529	\$ 1,804

The following table presents activity for assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the three and nine months ended September 30, 2016 (in thousands):

	Corporate Securities		Non-Agency Mortgage-Backed Securities	
	Three Months Ended September 30, 2016	Nine Months Ended September 30, 2016	Three Months Ended September 30, 2016	Nine Months Ended September 30, 2016
Balance, beginning of period	\$ 9,765	\$ —	\$ 2	\$ —
Transferred from Level 2	—	6,749	—	2
Transferred to Level 2	(2,000)	(2,000)	—	—
Purchases of investment securities recognized as Level 3	—	3,000	—	—
Total realized in earnings ⁽¹⁾	93	251	—	—
Total unrealized in other comprehensive income	(294)	(296)	—	—
Net settlements (principal and interest)	(84)	(224)	(1)	(1)
Balance, end of period	\$ 7,480	\$ 7,480	\$ 1	\$ 1

(1) Amounts included in interest income from investment securities taxable in the consolidated statements of income.

Midland States Bancorp, Inc.

Notes to Consolidated Financial Statements (Unaudited) (Continued)

The following table presents activity for assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the nine months ended September 30, 2015 (in thousands). There was no activity for the three months ended September 30, 2015.

	Covered Non- Agency Mortgage-Backed Securities
Balance, beginning of period	\$ 56,437
Total realized in earnings ⁽¹⁾	1,487
Transferred to Level 2	(55,910)
Net settlements (principal and interest)	(2,014)
Balance, end of period	\$ —

(1) Amounts included in interest income from investment securities taxable in the consolidated statements of income.

ASC Topic 825, *Financial Instruments*, requires disclosure of the estimated fair value of certain financial instruments and the methods and significant assumptions used to estimate such fair values. Additionally, certain financial instruments and all nonfinancial instruments are excluded from the applicable disclosure requirements.

Midland States Bancorp, Inc.

Notes to Consolidated Financial Statements (Unaudited) (Continued)

The following tables are a summary of the carrying values and fair value estimates of certain financial instruments as of September 30, 2016 and December 31, 2015 (in thousands):

	September 30, 2016				
	Carrying Amount	Fair Value	Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Assets					
Cash and due from banks	\$ 227,496	\$ 227,496	\$ 227,496	\$ —	\$ —
Federal funds sold	534	534	534	—	—
Investment securities available for sale	252,212	252,212	35,506	209,225	7,481
Investment securities held to maturity	82,941	88,590	—	88,590	—
Nonmarketable equity securities	18,810	18,810	—	18,810	—
Loans, net	2,297,219	2,316,066	—	—	2,316,066
Loans held for sale	61,363	61,363	—	61,363	—
Accrued interest receivable	8,811	8,811	—	8,811	—
Interest rate lock commitments	6,798	6,798	—	6,798	—
Liabilities					
Deposits	\$ 2,420,032	\$ 2,422,295	\$ —	\$ 2,422,295	\$ —
Short-term borrowings	138,289	138,289	—	138,289	—
FHLB and other borrowings	237,543	237,896	—	237,896	—
Subordinated debt	54,484	50,260	—	50,260	—
Trust preferred debentures	37,316	31,885	—	31,885	—
Accrued interest payable	1,875	1,875	—	1,875	—
Interest rate swap agreement	32	32	—	32	—
Forward commitments to sell mortgage-backed securities	244	244	—	244	—

	December 31, 2015				
	Carrying Amount	Fair Value	Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)	Significant unobservable inputs (Level 3)
Assets					
Cash and due from banks	\$ 211,976	\$ 211,976	\$ 211,976	\$ —	\$ —
Federal funds sold	499	499	499	—	—
Investment securities available for sale	236,627	236,627	48,302	188,325	—
Investment securities held to maturity	87,521	92,816	—	92,816	—
Nonmarketable equity securities	15,472	15,472	—	15,472	—
Loans, net	1,979,601	1,992,745	—	—	1,992,745
Loans held for sale	54,413	54,413	—	54,413	—
Accrued interest receivable	7,697	7,697	—	7,697	—
Interest rate lock commitments	6,029	6,029	—	6,029	—
Liabilities					
Deposits	\$ 2,367,648	\$ 2,371,397	\$ —	\$ 2,371,397	\$ —
Short-term borrowings	107,538	107,538	—	107,538	—
FHLB and other borrowings	40,178	40,054	—	40,054	—
Subordinated debt	61,859	58,198	—	58,198	—
Trust preferred debentures	37,057	33,537	—	33,537	—
Accrued interest payable	979	979	—	979	—
Interest rate swap agreement	126	126	—	126	—
Forward commitments to sell mortgage-backed securities	2	2	—	2	—

Midland States Bancorp, Inc.

Notes to Consolidated Financial Statements (Unaudited) (Continued)

The following is a description of the valuation methodologies used to measure our assets recorded at fair value (under ASC Topic 820) and for estimating fair value for financial instruments not recorded at fair value (under ASC Topic 825):

Cash and due from banks and federal funds sold. The carrying amounts are assumed to be the fair value because of the liquidity of these instruments.

Investment securities available for sale. Securities available for sale are measured and carried at fair value on a recurring basis. Unrealized gains and losses on available-for-sale securities are reported as a component of accumulated other comprehensive income in the consolidated balance sheets.

For securities available for sale where quoted prices are not available, fair values are calculated based on market prices of similar securities (Level 2). In determining the fair value of available-for-sale securities categorized as Level 2, we obtain a report from a nationally recognized broker-dealer detailing the fair value of each investment security we hold as of each reporting date. The broker-dealer uses observable market information to value our fixed income securities, with the primary source being a nationally recognized pricing service. The fair value of the municipal securities is based on a proprietary model maintained by the broker-dealer. We review all of the broker-dealer supplied quotes on the securities we own as of the reporting date for reasonableness based on our understanding of the marketplace and we consider any credit issues related to the bonds. As we have not made any adjustments to the market quotes provided to us and they are based on observable market data, they have been categorized as Level 2 within the fair value hierarchy.

For securities available for sale where quoted prices or market prices of similar securities are not available, fair values are calculated using discounted cash flows or other market indicators (Level 3). During the nine months ended September 30, 2016, \$6.7 million of corporate securities and \$2,000 of non-agency mortgage backed securities were transferred from Level 2 to Level 3 because observable market inputs were not available and the securities were not actively traded; therefore, the fair value was determined through consensus pricing and discounted cash flow models.

Corporate securities classified as Level 3 are not actively traded, and as a result, fair value is determined utilizing third-party valuation services through consensus pricing. The significant unobservable input used in the fair value measurement of Level 3 corporate securities is net market price (range of -2.5% to 2.5%; weighted average of 1.5%). Significant changes in any of the inputs in isolation would result in a significant change to the fair value measurement. Net market price generally increases when market interest rates decline and declines when market interest rates increase.

During both the three and nine months ended September 30, 2016, \$2.0 million of corporate securities were transferred from Level 3 to Level 2 because a more liquid market for these securities had developed and prices supported by observable market inputs had become available.

The fair value of non-agency mortgage backed securities classified as Level 3 is determined utilizing a discounted cash flow model. Significant unobservable inputs include discount rate (range of 4.0% - 14.0%; weighted average of 6.5%), cumulative prepayment rate (range of 0.0% - 100.0%; weighted average of 14.0%), cumulative default (range of 1.5% - 100%; weighted average of 11.0%), and loss given default (range of 85% - 100%; weighted average of 96.5%). In general, prepayment rates increase when market rates decline and decrease as market rates rise. Typically, higher prepayment rates result in lower fair values. Credit loss estimates are driven by the borrower's ability to pay their loans and the value of underlying collateral. These metrics typically increase when macroeconomic conditions worsen. Generally, discount rates increase with market interest rates and credit and liquidity risks increase. Higher discount rates and credit spreads typically result in lower fair market values.

During the nine months ended September 30, 2015, \$55.9 million of covered non-agency mortgage-backed securities were transferred from Level 3 to Level 2 because a more liquid market for these securities had developed and prices supported by observable market inputs had become available.

During the three months ended September 30, 2016, there was no OTTI recognized on investment securities available for sale. During the three months ended September 30, 2015, we recorded \$299,000 of OTTI, net of applicable loss-share reimbursements, on non-agency mortgage-backed securities covered by FDIC loss-sharing agreements.

Midland States Bancorp, Inc.

Notes to Consolidated Financial Statements (Unaudited) (Continued)

During the nine months ended September 30, 2016 and 2015, we recorded \$824,000 and \$461,000, respectively, of OTTI, net of applicable loss-share reimbursements, on non-agency mortgage-backed securities covered by FDIC loss-sharing agreements.

Investment securities held to maturity. Held-to-maturity securities are those debt instruments which the Company has the positive intent and ability to hold until maturity. Securities held to maturity are recorded at cost, adjusted for the amortization of premiums or accretion of discounts.

For securities held to maturity where quoted prices are not available, fair values are calculated based on market prices of similar securities (Level 2). In determining the fair value of held-to-maturity securities categorized as Level 2, we obtain a report from a nationally recognized broker-dealer detailing the fair value of each investment security we hold as of each reporting date. The fair value of the municipal securities is based on a proprietary model maintained by the broker-dealer. We review all of the broker-dealer supplied quotes on the securities we own as of the reporting date for reasonableness based on our understanding of the marketplace, and we consider any credit issues related to the bonds. As we have not made any adjustments to the market quotes provided to us and they are based on observable market data, they have been categorized as Level 2 within the fair value hierarchy.

Nonmarketable equity securities. The carrying amounts approximate their fair values.

Loans (excluding covered loans). Fair values are estimated for portfolios of loans with similar financial characteristics. Loans are segregated by type and further segmented into fixed and adjustable rate interest terms and by credit risk categories. The fair value estimates do not take into consideration the value of the loan portfolio in the event the loans have to be sold outside the parameters of normal operating activities. The fair value of performing fixed rate loans is estimated by discounting scheduled cash flows through the estimated maturity using estimated market prepayment speeds and estimated market discount rates that reflect the credit and interest rate risk inherent in the loans. The estimated market discount rates used for performing fixed rate loans are the Company's current offering rates for comparable instruments with similar terms. The fair value of performing adjustable rate loans is estimated by discounting scheduled cash flows through the next repricing date. As these loans reprice frequently at market rates and the credit risk is not considered to be greater than normal, the market value is typically close to the carrying amount of these loans. The method of estimating fair value does not incorporate the exit-price concept of fair value prescribed by ASC Topic 820.

Non-covered impaired loans. Non-covered impaired loans are measured and recorded at fair value on a non-recurring basis. All of our non-covered nonaccrual loans and restructured loans are considered impaired and are reviewed individually for the amount of impairment, if any. Most of our loans are collateral dependent and, accordingly, we measure impaired loans based on the estimated fair value of such collateral. The fair value of each loan's collateral is generally based on estimated market prices from an independently prepared appraisal, which is then adjusted for the cost related to liquidating such collateral; such valuation inputs result in a nonrecurring fair value measurement that is categorized as a Level 2 measurement. When adjustments are made to an appraised value to reflect various factors such as the age of the appraisal or known changes in the market or the collateral, such valuation inputs are considered unobservable and the fair value measurement is categorized as a Level 3 measurement. The impaired loans categorized as Level 3 also include unsecured loans and other secured loans whose fair values are based significantly on unobservable inputs such as the strength of a guarantor, cash flows discounted at the effective loan rate, and management's judgment. The loan balances shown in the above tables represent nonaccrual and restructured loans for which impairment was recognized during the three and nine months ended September 30, 2016 and 2015. The amounts shown as losses represent, for the loan balances shown, the impairment recognized during those same years.

Covered loans. Covered loans were measured at estimated fair value on the date of acquisition. Thereafter, the fair value of covered loans is measured using the same methodology as that for non-covered loans. The above discussion for non-covered loans and non-covered impaired loans is applicable to covered loans following their acquisition date.

Loans held for sale. Loans held for sale are carried at either fair value, if elected, or the lower of cost or fair value on an individual loan basis. Fair value measurements on loans held for sale are based on quoted market prices for similar loans in the secondary market. At September 30, 2016 and December 31, 2015, loans held for sale were carried at fair value.

Midland States Bancorp, Inc.

Notes to Consolidated Financial Statements (Unaudited) (Continued)

Other real estate owned. The fair value of foreclosed real estate, both non-covered and covered, is generally based on estimated market prices from independently prepared current appraisals or negotiated sales prices with potential buyers; such valuation inputs result in a fair value measurement that is categorized as a Level 2 measurement on a nonrecurring basis. When a current appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value as a result of known changes in the market or the collateral and there is no observable market price, such valuation inputs result in a fair value measurement that is categorized as a Level 3 measurement. To the extent a negotiated sales price or reduced listing price represents a significant discount to an observable market price, such valuation input would result in a fair value measurement that is also considered a Level 3 measurement.

Accrued interest receivable. The carrying amounts approximate their fair values.

Deposits. Deposits are carried at historical cost. The fair value of deposits with no stated maturity, such as noninterest-bearing demand deposits, money market, savings and checking accounts, is equal to the amount payable on demand as of the balance sheet date. The fair value of time deposits is based on the discounted value of contractual cash flows. The discount rate is estimated using the rates currently offered for deposits of similar remaining maturities.

Short-term borrowings. Short-term borrowings consist of repurchase agreements. These borrowings typically have terms of less than 30 days, and therefore, their carrying amounts are a reasonable estimate of fair value.

FHLB advances and other borrowings and subordinated debt. Borrowings are carried at amortized cost. The fair value of fixed rate borrowings is calculated by discounting scheduled cash flows through the estimated maturity or call dates using estimated market discount rates that reflect rates offered at that time for borrowings with similar remaining maturities and other characteristics.

Trust preferred debentures. Debentures are carried at amortized cost. The fair value of variable rate debentures is calculated by discounting scheduled cash flows through the estimated maturity or call dates using estimated market discount rates that reflect spreads offered at that time for borrowings with similar remaining maturities and other characteristics.

Accrued interest payable. The carrying amounts approximate their fair values.

Derivative financial instruments. The Company enters into interest rate lock commitments which are agreements to originate mortgage loans whereby the interest rate on the loan is determined prior to funding and the customers have locked into that interest rate. These commitments are carried at fair value in other assets on the consolidated balance sheet with changes in fair value reflected in commercial FHA revenue and residential mortgage banking revenue in the consolidated statements of income. The Company also has forward loan sales commitments related to its interest rate lock commitments and its loans held for sale. These commitments are carried at fair value in other assets or other liabilities on the consolidated balance sheet with changes in fair value reflected in commercial FHA revenue and residential mortgage banking revenue in the consolidated statements of income. The interest rate swap is carried at fair value on a recurring basis based upon the amounts required to settle the contracts.

Note 18 – Commitments, Contingencies and Credit Risk

In the normal course of business, there are outstanding various contingent liabilities such as claims and legal actions, which are not reflected in the consolidated financial statements. No material losses are anticipated as a result of these actions or claims.

We are a party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of our customers. These financial instruments include commitments to extend credit and standby letters of credit. Those instruments involve, to varying degrees, elements of credit risk in excess of the amount recognized in the balance sheet. The contract amounts of those instruments reflect the extent of involvement we have in particular classes of financial instruments.

Midland States Bancorp, Inc.

Notes to Consolidated Financial Statements (Unaudited) (Continued)

Our exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual amount of those instruments. The Bank used the same credit policies in making commitments and conditional obligations as it does for on-balance-sheet instruments. The commitments are principally tied to variable rates. Loan commitments as of September 30, 2016 and December 31, 2015 are as follows (in thousands):

	September 30, 2016	December 31, 2015
Commitments to extend credit	\$ 504,937	\$ 495,506
Financial guarantees – standby letters of credit	35,608	31,029

The Company sells residential mortgage loans to investors in the normal course of business. Residential mortgage loans sold to others are predominantly conventional residential first lien mortgages originated under our usual underwriting procedures, and are sold on a nonrecourse basis, primarily to government-sponsored enterprises (“GSEs”). The Company’s agreements to sell residential mortgage loans in the normal course of business usually require certain representations and warranties on the underlying loans sold, related to credit information, loan documentation, collateral, and insurability. Subsequent to being sold, if a material underwriting deficiency or documentation defect is discovered, the Company may be obligated to repurchase the loan or reimburse the GSEs for losses incurred. The make-whole requests and any related risk of loss under the representations and warranties are largely driven by borrower performance. The Company establishes a mortgage repurchase liability related to these events that reflect management’s estimate of losses on loans for which the Company could have a repurchase obligation based on a combination of factors. Such factors incorporate the volume of loans sold in 2016 and years prior, borrower default expectations, historical investor repurchase demand and appeals success rates, and estimated loss severity. Loans repurchased from investors are initially recorded at fair value, which becomes the Company’s new accounting basis. Any difference between the loan’s fair value and the outstanding principal amount is charged or credited to the mortgage repurchase liability, as appropriate. Subsequent to repurchase, such loans are carried in loans receivable. As a result of make-whole requests and loan repurchases, the Company incurred losses totaling \$83,000 for the nine months ended September 30, 2016, and \$12,000 and \$65,000 for the three and nine months ended September 30, 2015, respectively. There were no losses incurred for the three months ended September 30, 2016. The liability for unresolved repurchase demands totaled \$340,000 and \$378,000 at September 30, 2016 and December 31, 2015, respectively.

Note 19 – Segment Information

Our business segments are defined as Banking, Commercial FHA Origination and Servicing, and Other. The reportable business segments are consistent with the internal reporting and evaluation of the principle lines of business of the Company. The banking segment provides a wide range of financial products and services to consumers and businesses, including commercial, commercial real estate, mortgage and other consumer loan products; commercial equipment leasing; mortgage loan sales and servicing; letters of credit; various types of deposit products, including checking, savings and time deposit accounts; merchant services; and corporate treasury management services. The commercial FHA origination and servicing segment provides for the origination and servicing of government sponsored mortgages for multifamily and healthcare facilities. The other segment includes the operating results of the parent company, our wealth management business unit, and the elimination of intercompany transactions. Wealth management activities consist of trust and fiduciary services, brokerage and retirement planning services.

Midland States Bancorp, Inc.

Notes to Consolidated Financial Statements (Unaudited) (Continued)

Selected business segment financial information as of and for the three and nine months ended September 30, 2016 and 2015 were as follows (in thousands):

	Banking	Commercial FHA Origination and Servicing	Other	Total
Three Months Ended September 30, 2016				
Net interest income (expense)	\$ 28,394	\$ 215	\$ (1,344)	\$ 27,265
Provision for loan losses	1,392	—	—	1,392
Noninterest income	9,714	3,557	1,666	14,937
Noninterest expense	23,646	3,511	1,506	28,663
Income (loss) before income taxes (benefit)	13,070	261	(1,184)	12,147
Income taxes (benefit)	4,573	104	(575)	4,102
Net income (loss)	\$ 8,497	\$ 157	\$ (609)	\$ 8,045
Total assets	\$ 3,252,421	\$ 100,516	\$ (105,210)	\$ 3,247,727
Three Months Ended September 30, 2015				
Net interest income (expense)	\$ 26,513	\$ 348	\$ (1,424)	\$ 25,437
Provision for loan losses	6,699	—	—	6,699
Noninterest income	8,284	6,124	56	14,464
Noninterest expense	22,848	3,783	1,192	27,823
Income (loss) before income taxes (benefit)	5,250	2,689	(2,560)	5,379
Income taxes (benefit)	1,326	1,097	(495)	1,928
Net income (loss)	\$ 3,924	\$ 1,592	\$ (2,065)	\$ 3,451
Total assets	\$ 2,838,074	\$ 82,991	\$ (88,757)	\$ 2,832,308
	Banking	Commercial FHA Origination and Servicing	Other	Total
Nine Months Ended September 30, 2016				
Net interest income (expense)	\$ 82,939	\$ 712	\$ (4,357)	\$ 79,294
Provision for loan losses	3,146	—	—	3,146
Noninterest income	21,347	19,212	1,013	41,572
Noninterest expense	69,790	12,203	5,212	87,205
Income (loss) before income taxes (benefit)	31,350	7,721	(8,556)	30,515
Income taxes (benefit)	9,348	3,088	(1,874)	10,562
Net income (loss)	\$ 22,002	\$ 4,633	\$ (6,682)	\$ 19,953
Total assets	\$ 3,252,421	\$ 100,516	\$ (105,210)	\$ 3,247,727
Nine Months Ended September 30, 2015				
Net interest income (expense)	\$ 80,406	\$ 1,240	\$ (3,191)	\$ 78,455
Provision for loan losses	10,075	—	—	10,075
Noninterest income	28,427	16,916	1,340	46,683
Noninterest expense	74,005	11,675	4,391	90,071
Income (loss) before income taxes (benefit)	24,753	6,481	(6,242)	24,992
Income taxes (benefit)	6,936	2,614	(1,269)	8,281
Net income (loss)	\$ 17,817	\$ 3,867	\$ (4,973)	\$ 16,711
Total assets	\$ 2,838,074	\$ 82,991	\$ (88,757)	\$ 2,832,308

Note 20 – Related Party Transactions

The Company utilizes the services of a company to act as a general manager for the construction of new branch facilities. A member of our board of directors is a substantial shareholder of this company and currently serves as its Chairman. During the three months ended September 30, 2015, the Company paid \$738,000 for work on various projects. There were no payments made during the three months ended September 30, 2016. During the nine months ended September 30, 2016 and 2015, the Company paid \$159,000 and \$1.6 million, respectively, for work on various projects.

A member of our board of directors has an ownership interest in the office building located in Clayton, Missouri and three of the Bank's full-service branch facilities. During the three and nine months ended September 30, 2016, the Company paid rent of \$165,000 and \$540,000, respectively, and \$166,000 and \$527,000 for the comparable periods in 2015, respectively.

Midland States Bancorp, Inc.

Notes to Consolidated Financial Statements (Unaudited) (Continued)

Note 21 – Subsequent Events

On October 3, 2016, the Company entered into an agreement with the FDIC to terminate its existing loss share agreements. The loss share agreements were related to certain assets the Bank acquired from the FDIC as part of the two FDIC-assisted bank acquisitions it had completed, one in 2009 and one in 2010. Under the terms of this agreement, the Company paid the FDIC \$565,000 as consideration for the early termination. This charge was partially offset by the reversal of \$214,000 of accrued loss-share liabilities that will not be paid, resulting in a one-time after tax charge of \$225,000. All future gains, recoveries, charge-offs, losses and expenses related to the formerly covered assets will now be recognized by the Company with no offset due to or from the FDIC.

On October 4, 2016, the Company sold previously covered non-agency mortgage-backed securities which had a carrying value of \$72.1 million. As a result of the sale, the Company realized a gain totaling \$14.3 million in the fourth quarter of 2016.

Item 2 – Management’s Discussion and Analysis of Financial Condition and Results of Operations

The following discussion explains our financial condition and results of operations as of and for the three and nine months ended September 30, 2016. Annualized results for these interim periods may not be indicative of results for the full year or future periods. The following discussion and analysis should be read in conjunction with the consolidated financial statements and related notes presented elsewhere in this report and our Registration Statement on Form S-1, which contains audited financial statements of the Company as of and for the year ended December 31, 2015, previously filed with the SEC on May 23, 2016.

In addition to the historical information contained herein, this Form 10-Q includes "forward-looking statements" within the meaning of such term in the Private Securities Litigation Reform Act of 1995. These statements are subject to many risks and uncertainties, including changes in interest rates and other general economic, business and political conditions, including changes in the financial markets; changes in business plans as circumstances warrant; and other risks detailed from time to time in filings made by the Company with the SEC. Readers should note that the forward-looking statements included herein are not a guarantee of future events, and that actual events may differ materially from those made in or suggested by the forward-looking statements. Forward-looking statements generally can be identified by the use of forward-looking terminology such as "will," "propose," "may," "plan," "seek," "expect," "intend," "estimate," "anticipate," "believe" or "continue," or similar terminology. Any forward-looking statements presented herein are made only as of the date of this document, and we do not undertake any obligation to update or revise any forward-looking statements to reflect changes in assumptions, the occurrence of unanticipated events, or otherwise.

Critical Accounting Policies

The preparation of our consolidated financial statements requires management to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses. These estimates are based upon historical experience and on various other assumptions that management believes are reasonable under current circumstances. These estimates form the basis for making judgments about the carrying value of certain assets and liabilities that are not readily available from other sources. Actual results may differ from these estimates under different assumptions or conditions. The estimates and judgments that management believes have the most effect on its reported financial position and results of operations are set forth in Note 1 – Summary of Significant Accounting Policies of the Notes to Consolidated Financial Statement in our consolidated financial statements as of and for the periods ended December 31, 2015, 2014 and 2013, included in our registration statement on Form S-1 filed with the SEC on May 23, 2016. There have been no significant changes in critical accounting policies or the assumptions and judgments utilized in applying these policies since the year ended December 31, 2015.

Overview

Midland States Bancorp, Inc. is a diversified financial holding company headquartered in Effingham, Illinois. Our 135-year old banking subsidiary, Midland States Bank, has branches across Illinois and in St. Louis, Missouri and Denver, Colorado, and provides a broad array of traditional community banking and other complementary financial services, including lending, residential mortgage origination, wealth management, merchant services and prime consumer lending. Our commercial FHA origination and servicing business, Love Funding, based in Washington, D.C., is one of the largest originators of government sponsored mortgages for multifamily and healthcare facilities in the United States. Our commercial equipment leasing business, Business Credit, based in Denver, provides financing to business customers across the country.

Our principal business activity is lending to and accepting deposits from individuals, businesses, municipalities and other entities. We have derived income principally from interest charged on loans and, to a lesser extent, from interest and dividends earned on investment securities. We have also derived income from noninterest sources, such as: fees received in connection with various lending and deposit services; wealth management services; residential mortgage loan originations, sales and servicing; merchant services; and, from time to time, gains on sales of assets. With the acquisition of Heartland Bank at the end of 2014, we expanded our income sources to include a greater emphasis on residential mortgage loan origination and servicing, commercial FHA origination and servicing and commercial equipment leasing. Our principal expenses include interest expense on deposits and borrowings, operating expenses, such as salaries and employee benefits, occupancy and equipment expenses, data processing costs, professional fees and other noninterest expenses, provisions for loan losses and income tax expense.

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Significant Transactions

Each item listed below materially affects the comparability of our results of operations and financial condition as of and for the three and nine months ended September 30, 2016 and 2015, or may affect the comparability of financial information we report in future fiscal periods.

Initial Public Offering. On May 24, 2016, the Company completed its initial public offering and received gross proceeds of \$67.0 million for the 3,044,252 shares of common stock sold by us in the offering. On June 6, 2016, the Company received additional gross proceeds of \$12.0 million for the 545,813 shares of common stock sold when the underwriters associated with the initial public offering fully exercised their option to purchase additional shares of common stock. After deducting underwriting discounts and offering expenses, the Company received total net proceeds of \$71.5 million from the initial public offering.

Subordinated Debt. On June 28, 2013, the Company issued to a third party \$8.0 million of subordinated notes with an interest rate of 8.25%. Using proceeds from the initial public offering, the Company repaid these subordinated notes on June 28, 2016 and incurred other noninterest expense of \$0.5 million for the write-off of the remaining unamortized discount that was established when the subordinated notes were issued.

Purchased Credit-Impaired Loans. Our net interest margin benefits from favorable changes in expected cash flows on our PCI loans and from accretion income associated with purchase accounting discounts established on the non-PCI loans included in our acquisitions. For the three and nine months ended September 30, 2016, our reported net interest margin was 4.00% and 4.01%, respectively, which included accretion income of \$2.6 million and \$9.5 million, respectively. Excluding the impact of accretion income would have reduced our net interest margin to 3.66% and 3.58% for the three and nine months ended September 30, 2016, respectively. For the three and nine months ended September 30, 2015, our reported net interest margin was 4.17% and 4.45%, respectively, which included accretion income of \$2.6 million and \$11.4 million, respectively. Excluding the impact of accretion income would have reduced our net interest margin to 3.83% and 3.87% for the three and nine months ended September 30, 2015, respectively.

During the second quarter of 2016, we received payment in full on a PCI loan that was a covered asset from an FDIC-assisted acquisition. We recognized the financial impact of this transaction by recording \$1.8 million of accretion income into interest income on loans and a \$0.8 million credit against the provision for loan losses offsetting the allowance amount that was previously recorded against this loan. In accordance with the loss-sharing agreement with the FDIC, we also recorded loss-sharing expense of \$1.5 million for reimbursement of covered losses previously paid by the FDIC on this loan.

Mortgage Servicing Rights. Mortgage servicing rights are carried at the lower of the initial capitalized amount, net of accumulated amortization, or estimated fair value. Our mortgage servicing rights are amortized in proportion to and over the period of estimated net servicing income, and assessed for impairment at each reporting date. Impairment charges on our residential mortgage servicing rights totaled \$22,000 and \$5.0 million during the three and nine months ended September 30, 2016, respectively, as decreases in long-term interest rates resulted in corresponding increases in estimated prepayment speeds primarily at the end of the first and second quarters of 2016. For the three and nine months ended September 30, 2015, we recorded impairment charges on our residential mortgage servicing rights totaling \$0.8 million and \$0.7 million, respectively.

Impairment charges on our commercial mortgage servicing rights totaled \$1.1 million for both the three and nine months ended September 30, 2016. We recorded no impairment charges during the three and nine months ended September 30, 2015.

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Results of Operations – Comparison of Results of Operations for the Three and Nine Months Ended September 30, 2016 and 2015

The following discussion of our results of operations compares the three and nine months ended September 30, 2016 to the corresponding three and nine months ended September 30, 2015. The results of operations for the three and nine months ended September 30, 2016 are not necessarily indicative of the results of operations that may be expected for the year ending December 31, 2016.

Average Balance Sheet, Interest and Yield/Rate Analysis. The following tables present average balance sheet information, interest income, interest expense and the corresponding average yields earned and rates paid for the three and nine months ended September 30, 2016 and 2015. The average balances are daily averages and, for loans, include both performing and nonperforming balances. Interest income on loans includes the effects of discount accretion and net deferred loan origination costs accounted for as yield adjustments.

(tax-equivalent basis, dollars in thousands)	For the Three Months Ended September 30,					
	2016			2015		
	Average Balance	Interest & Fees	Yield / Rate	Average Balance	Interest & Fees	Yield / Rate
EARNING ASSETS:						
Federal funds sold & cash investments	\$ 154,764	\$ 195	0.50 %	\$ 133,677	\$ 82	0.24 %
<i>Investment securities:</i>						
Taxable investment securities	248,035	2,940	4.71	214,765	2,784	5.14
Investment securities exempt from federal income tax ⁽¹⁾	100,230	1,373	5.45	103,121	1,487	5.72
Total securities	348,265	4,313	4.93	317,886	4,271	5.33
<i>Loans:</i>						
Loans ⁽²⁾	2,227,303	26,905	4.81	1,993,684	24,807	4.94
Loans exempt from federal income tax ⁽¹⁾	40,875	391	3.80	38,438	476	4.90
Total loans	2,268,178	27,296	4.79	2,032,122	25,283	4.94
Total earning assets	2,771,207	\$ 31,804	4.57 %	2,483,685	\$ 29,636	4.73 %
Noninterest-earning assets	329,504			311,539		
Total assets	\$ 3,100,711			\$ 2,795,224		
INTEREST-BEARING LIABILITIES						
NOW and money market deposits	\$ 1,008,028	\$ 448	0.18 %	\$ 951,014	\$ 381	0.16 %
Savings deposits	163,867	62	0.15	158,089	54	0.14
Time deposits	425,269	957	0.90	412,830	808	0.78
Brokered deposits	206,025	722	1.39	211,966	678	1.27
Total interest-bearing deposits	1,803,189	2,189	0.48	1,733,899	1,921	0.44
Short-term borrowings	134,052	81	0.24	121,453	56	0.18
FHLB advances and other borrowings	165,774	306	0.73	54,056	111	0.81
Subordinated debt	54,470	873	6.38	61,847	1,054	6.76
Trust preferred debentures	37,266	472	5.03	37,006	370	3.97
Total interest-bearing liabilities	2,194,751	\$ 3,921	0.71 %	2,008,261	\$ 3,512	0.69 %
NONINTEREST-BEARING LIABILITIES						
Noninterest-bearing deposits	550,816			515,750		
Other noninterest-bearing liabilities	36,235			38,926		
Total noninterest-bearing liabilities	587,051			554,676		
Shareholders' equity	318,909			232,287		
Total liabilities and shareholders' equity	\$ 3,100,711			\$ 2,795,224		
Net interest income / net interest margin ⁽³⁾		\$ 27,883	4.00 %		\$ 26,124	4.17 %

(1) Interest income and average rates for tax-exempt loans and securities are presented on a tax-equivalent basis, assuming a federal income tax rate of 35%. Tax-equivalent adjustments totaled \$0.6 million and \$0.7 million for the three months ended September 30, 2016 and 2015, respectively.

(2) Average loan balances include nonaccrual loans and loans held for sale. Interest income on loans includes amortization of deferred loan fees, net of deferred loan costs.

(3) Net interest margin during the periods presented represents: (i) the difference between interest income on interest-earning assets and the interest expense on interest-bearing liabilities, divided by (ii) average interest-earning assets for the period.

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(tax-equivalent basis, dollars in thousands)	For the Nine Months Ended September 30,					
	2016			2015		
	Average Balance	Interest & Fees	Yield / Rate	Average Balance	Interest & Fees	Yield / Rate
EARNING ASSETS:						
Federal funds sold & cash investments	\$ 203,514	\$ 762	0.50 %	\$ 145,702	\$ 262	0.24 %
<i>Investment securities:</i>						
Taxable investment securities	237,972	8,726	4.89	219,727	8,589	5.23
Investment securities exempt from federal income tax ⁽¹⁾	99,985	4,215	5.62	103,428	4,572	5.91
Total securities	337,957	12,941	5.11	323,155	13,161	5.45
<i>Loans:</i>						
Loans ⁽²⁾	2,126,477	78,142	4.91	1,912,210	74,821	5.23
Loans exempt from federal income tax ⁽¹⁾	41,742	1,382	4.42	36,607	1,311	4.79
Total loans	2,168,219	79,524	4.90	1,948,817	76,132	5.22
Total earning assets	2,709,690	\$ 93,227	4.60 %	2,417,674	\$ 89,555	4.95 %
Noninterest-earning assets	323,937			313,628		
Total assets	\$ 3,033,627			\$ 2,731,302		
INTEREST-BEARING LIABILITIES						
NOW and money market deposits	\$ 1,010,734	\$ 1,391	0.18 %	\$ 934,352	\$ 1,130	0.16 %
Savings deposits	162,890	181	0.15	160,844	156	0.13
Time deposits	436,975	2,933	0.90	403,293	2,166	0.72
Brokered deposits	216,075	2,196	1.36	187,072	1,868	1.34
Total interest-bearing deposits	1,826,674	6,701	0.49	1,685,561	5,320	0.42
Short-term borrowings	123,191	217	0.24	116,280	176	0.20
FHLB advances and other borrowings	150,213	698	0.62	68,117	634	1.24
Subordinated debt	59,324	2,985	6.72	30,870	1,671	7.24
Trust preferred debentures	37,181	1,373	4.93	37,010	1,240	4.48
Total interest-bearing liabilities	2,196,583	\$ 11,974	0.73 %	1,937,838	\$ 9,041	0.62 %
NONINTEREST-BEARING LIABILITIES						
Noninterest-bearing deposits	528,238			529,773		
Other noninterest-bearing liabilities	34,067			37,168		
Total noninterest-bearing liabilities	562,305			566,941		
Shareholders' equity	274,739			226,523		
Total liabilities and shareholders' equity	\$ 3,033,627			\$ 2,731,302		
Net interest income / net interest margin ⁽³⁾		\$ 81,253	4.01 %		\$ 80,514	4.45 %

(1) Interest income and average rates for tax-exempt loans and securities are presented on a tax-equivalent basis, assuming a federal income tax rate of 35%. Tax-equivalent adjustments totaled \$2.0 million and \$2.1 million for the nine months ended September 30, 2016 and 2015, respectively.

(2) Average loan balances include nonaccrual loans and loans held for sale. Interest income on loans includes amortization of deferred loan fees, net of deferred loan costs.

(3) Net interest margin during the periods presented represents: (i) the difference between interest income on interest-earning assets and the interest expense on interest-bearing liabilities, divided by (ii) average interest-earning assets for the period.

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Interest Rates and Operating Interest Differential. Increases and decreases in interest income and interest expense result from changes in average balances (volume) of interest-earning assets and interest-bearing liabilities, as well as changes in average interest rates. The following table shows the effect that these factors had on the interest earned on our interest-earning assets and the interest incurred on our interest-bearing liabilities. The effect of changes in volume is determined by multiplying the change in volume by the previous period's average rate. Similarly, the effect of rate changes is calculated by multiplying the change in average rate by the previous period's volume. Changes which are not due solely to volume or rate have been allocated proportionately to the change due to volume and the change due to rate.

(tax-equivalent basis, dollars in thousands)	Three Months Ended September 30, 2016 Compared with Three Months Ended September 30, 2015			Nine Months Ended September 30, 2016 Compared with Nine Months Ended September 30, 2015		
	Change due to:		Interest Variance	Change due to:		Interest Variance
	Volume	Rate		Volume	Rate	
EARNING ASSETS:						
Federal funds sold & cash investments	\$ 20	\$ 93	\$ 113	\$ 161	\$ 339	\$ 500
<i>Investment securities:</i>						
Taxable investment securities	409	(253)	156	704	(567)	137
Investment securities exempt from federal income tax	(43)	(71)	(114)	(142)	(215)	(357)
Total securities	366	(324)	42	562	(782)	(220)
<i>Loans:</i>						
Loans	2,826	(728)	2,098	8,166	(4,845)	3,321
Loans exempt from federal income tax	26	(111)	(85)	177	(106)	71
Total loans	2,852	(839)	2,013	8,343	(4,951)	3,392
Total earning assets	\$3,238	\$(1,070)	\$ 2,168	\$9,066	\$(5,394)	\$ 3,672
INTEREST-BEARING LIABILITIES						
NOW and money market deposits	\$ 23	\$ 44	\$ 67	\$ 99	\$ 162	\$ 261
Savings deposits	2	6	8	2	23	25
Time deposits	25	124	149	205	562	767
Brokered deposits	(21)	65	44	293	35	328
Total interest-bearing deposits	29	239	268	599	782	1,381
Short-term borrowings	7	18	25	11	30	41
FHLB advances and other borrowings	217	(22)	195	573	(509)	64
Subordinated debt	(123)	(58)	(181)	1,488	(174)	1,314
Trust preferred debentures	3	99	102	7	126	133
Total interest-bearing liabilities	\$ 133	\$ 276	\$ 409	\$2,678	\$ 255	\$ 2,933
Net interest income	\$3,105	\$(1,346)	\$ 1,759	\$6,388	\$(5,649)	\$ 739

Net Interest Income/Average Balance Sheet. Our primary source of revenue is net interest income, which is the difference between interest income from earning assets (primarily loans and securities) and interest expense of funding sources (primarily interest-bearing deposits and borrowings). Net interest income is impacted by the level of interest-earning assets and related funding sources, as well as changes in the levels of interest rates. Noninterest-bearing sources of funds, such as demand deposits and shareholders' equity, also support earning assets. The impact of the noninterest-bearing sources of funds is captured in the net interest margin, which is calculated as net interest income divided by average interest-earning assets. Net interest margin is presented on a tax-equivalent basis, which means that tax-free interest income has been adjusted to a pretax equivalent income, assuming a 35% tax rate.

In the third quarter of 2016, we generated \$27.9 million of net interest income on a tax-equivalent basis, which was an increase of \$1.8 million, or 6.7%, from the \$26.1 million of net interest income we produced on a tax-equivalent basis in the third quarter of 2015. This increase in net interest income was primarily due to a \$2.2 million increase in interest income on a tax-equivalent basis, offset in part by a \$0.4 million increase in interest expense. The increase in interest income was primarily attributable to an increase in interest income on loans. The increase in interest expense primarily resulted from increases in interest expense on deposits, FHLB advances and trust preferred debentures, offset in part by a decrease in interest expense on subordinated debt. For the three months ended September 30, 2016 and 2015, our reported net interest margin was 4.00% and 4.17%, respectively. Our net interest margin benefits from discount accretion on our purchased loan portfolios. Our net interest margin for the three months ended September 30, 2016 and 2015, excluding accretion income would have been 3.66% and 3.83%, respectively.

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For the first nine months of 2016, net interest income on a tax-equivalent basis was \$81.3 million, an increase of \$0.7 million, or 0.9%, from the \$80.5 million of net interest income we generated on a tax-equivalent basis for the first nine months of the prior year. This increase was mainly due to a \$3.7 million increase in interest income on a tax-equivalent basis, offset in part by a \$2.9 million increase in interest expense. The increase in interest income was primarily attributable to increases in interest income on loans and cash investments. The increase in interest expense primarily resulted from increases in interest expense on deposits and subordinated debt. For the nine months ended September 30, 2016 and 2015, our reported net interest margin was 4.01% and 4.45%, respectively. The decrease in our reported net interest margin resulted partially from a reduction in accretion income associated with purchase accounting discounts established on loans acquired. Our net interest margin for the nine months ended September 30, 2016 and 2015, excluding accretion income would have been 3.58% and 3.87%, respectively.

Interest Income. Total interest income on a tax-equivalent basis was \$31.8 million and \$93.2 million for the three and nine months ended September 30, 2016, respectively, compared to \$29.6 million and \$89.6 million for the three and nine months ended September 30, 2015, respectively. These increases were primarily attributable to increases in interest income on loans and cash investments.

Interest income on loans for the third quarter of 2016 was \$27.3 million compared to \$25.3 million for the same quarter in 2015. The \$2.0 million, or 8.0%, increase was primarily due to an 11.6% increase in the average balance of loans outstanding offset in part by a 15 basis point decrease in the average yield on loans. The increase in the average balance of loans outstanding was primarily due to growth in all loan categories, especially commercial real estate loans, residential real estate loans, consumer loans and lease financings. The lower yield on loans resulted primarily from the impact of lower market rates on new loans. Accretion income associated with purchase accounting discounts established on acquired loans totaled \$2.6 million in both the third quarter of 2016 and the third quarter of 2015. The average rate on loans benefits from purchase accounting discount accretion on loan portfolios acquired. For the three months ended September 30, 2016 and 2015, the reported yield on total loans was 4.79% and 4.94%, respectively, while the yield on total loans excluding accretion income would have been 4.38% and 4.53%, respectively. We expect accretion income to continue declining in the fourth quarter of 2016 in comparison to the corresponding period in 2015.

For the nine months ended September 30, 2016, interest income on loans was \$79.5 million compared to \$76.1 million for the corresponding period in 2015. The \$3.4 million, or 4.5%, increase in interest income on loans was primarily due to an 11.3% increase in the average balance of loans outstanding offset in part by a 32 basis point decrease in the average yield on loans. The increase in the average balance of loans outstanding was primarily due to growth in all loan categories, especially commercial real estate loans, residential real estate loans, consumer loans and lease financings. The decline in the average yield on loans was primarily driven by a \$1.9 million decrease in accretion income from purchase accounting discounts on acquired loans combined with the impact of lower market rates on new loans. Accretion income totaled \$9.5 million for the first nine months of 2016 compared to \$11.4 million for the corresponding period in 2015. For the nine months ended September 30, 2016 and 2015, the reported yield on total loans was 4.90% and 5.22%, respectively, while the yield on total loans excluding accretion income would have been 4.37% and 4.50%, respectively. The decline in accretion income resulted from continued run-off of higher yielding acquired loans.

Interest income on our investment securities portfolio was \$4.3 million for both the third quarter of 2016 and the third quarter of 2015. A 9.6% increase in the average balance of investment securities was offset by a 40 basis point decrease in the average yield on investment securities. Interest income on our investment securities portfolio decreased \$0.2 million, or 1.7%, to \$12.9 million in the first nine months of 2016 compared to the first nine months of 2015. This decrease was mainly attributable to a 34 basis point decline in the average yield on investment securities offset in part by a 4.6% increase in the average balance of investment securities. The lower yields on investment securities for the three- and nine-month periods in 2016 were mainly attributable to the proceeds from amortizing, sold and maturing investment securities being reinvested at lower market interest rates.

Interest income on short-term cash investments increased to \$0.2 million and \$0.8 million for the three and nine months ended September 30, 2016, respectively, compared to \$0.1 million and \$0.3 million for the three and nine months ended September 30, 2015. These increases were both due to an increase in short-term interest rates combined with an increase in the level of short-term cash investments.

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Interest Expense. Interest expense on interest-bearing liabilities increased \$0.4 million, or 11.6%, to \$3.9 million for the third quarter of 2016, and \$2.9 million, or 32.4%, to \$12.0 million for the nine months ended September 30, 2016.

Interest expense on deposits increased to \$2.2 million and \$6.7 million for the three and nine months ended September 30, 2016, respectively, as compared to \$1.9 million and \$5.3 million for the three and nine months ended September 30, 2015, respectively. The \$0.3 million, or 14.0%, increase in interest expense on deposits for the third quarter of 2016 was primarily due to a four basis point increase in the average rate paid. For the nine-month period, the \$1.4 million, or 26.0%, increase in interest expense on deposits was attributable to the average balance of deposits increasing 8.4% coupled with a seven basis point increase in the average rate paid. The increases in the average rate paid for both the three- and nine-month periods of 2016 were primarily due to increases in market rates. The increase in the average balance of deposits for the nine-month period of 2016 resulted primarily from growth in NOW and money market deposits, time deposits and brokered deposits.

Interest expense on borrowings increased to \$1.7 million and \$5.3 million for the three and nine months ended September 30, 2016, respectively, as compared to \$1.6 million and \$3.7 million for the three and nine months ended September 30, 2015, respectively. The \$0.1 million increase in interest expense on borrowings for the third quarter of 2016 was primarily due to increased usage of FHLB advances and higher rates on trust preferred debentures being offset in part by a decrease in interest expense on subordinated debt. The \$0.2 million decrease in interest expense on subordinated debt for the third quarter of 2016 was primarily due to the payoff of \$8.0 million of subordinated debt on June 28, 2016. For the nine-month period, the \$1.6 million, or 41.7%, increase in interest expense on borrowings in 2016 was mainly attributable to the issuance of \$55.3 million of subordinated debt in June 2015.

Provision for Loan Losses. The provision for loan losses totaled \$1.4 million and \$3.1 million for the three and nine months ended September 30, 2016, respectively, compared to \$6.7 million and \$10.1 million for the three and nine months ended September 30, 2015, respectively. The provision for loan losses decreased \$5.3 million and \$6.9 million for the three and nine months ended September 30, 2016, respectively, due primarily to the prior year third quarter including specific reserves for impairment identified on certain nonperforming loans. During the third quarter of 2015, we recorded a \$7.5 million charge-off on a group of nonperforming loans to one borrower due to deterioration in the Company's collateral position on these loans. The provisions for loan losses recorded during the three- and nine-month periods of 2016 were primarily due to growth in our loan portfolios. For the nine months ended September 30, 2016, the provision for loan losses was impacted by a \$0.8 million provision reduction related to a PCI loan that was paid in full during the second quarter of 2016 (see "Significant Transactions – Purchased Credit-Impaired Loans" above).

Noninterest Income. Noninterest income totaled \$14.9 million in the third quarter of 2016 compared to \$14.5 million in the third quarter of 2015. For the nine months ended September 30, 2016, noninterest income decreased \$5.1 million, or 10.9%, to \$41.6 million. The following tables set forth the major components of our noninterest income for the three and nine months ended September 30, 2016 and 2015:

(dollars in thousands)	For the Three Months		
	Ended		Increase (decrease)
	September 30, 2016	2015	
<i>Noninterest income:</i>			
Commercial FHA revenue	\$ 3,260	\$ 5,914	\$ (2,654)
Residential mortgage banking revenue	4,990	3,490	1,500
Wealth management revenue	1,941	1,808	133
Merchant services revenue	427	419	8
Service charges on deposit accounts	1,044	1,022	22
Interchange revenue	920	895	25
FDIC loss-sharing expense	—	(57)	57
Gain on sales of investment securities, net	39	1	38
Other-than-temporary impairment on investment securities	—	(299)	299
Gain on sales of other real estate owned	33	92	(59)
Other income	2,283	1,179	1,104
Total noninterest income	<u>\$ 14,937</u>	<u>\$ 14,464</u>	<u>\$ 473</u>

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(dollars in thousands)	For the Nine Months		
	Ended		Increase
	September 30,		
	2016	2015	(decrease)
<i>Noninterest income:</i>			
Commercial FHA revenue	\$ 18,360	\$ 17,130	\$ 1,230
Residential mortgage banking revenue	7,148	14,305	(7,157)
Wealth management revenue	5,596	5,461	135
Merchant services revenue	1,287	1,097	190
Service charges on deposit accounts	2,916	2,990	(74)
Interchange revenue	2,829	2,703	126
FDIC loss-sharing expense	(1,661)	(354)	(1,307)
Gain on sales of investment securities, net	315	160	155
Other-than-temporary impairment on investment securities	(824)	(461)	(363)
Gain on sales of other real estate owned	112	417	(305)
Other income	5,494	3,235	2,259
Total noninterest income	<u>\$ 41,572</u>	<u>\$ 46,683</u>	<u>\$ (5,111)</u>

Commercial FHA revenue. Love Funding is an approved FHA insured lender and Government National Mortgage Association (“GNMA”) issuer engaged in commercial FHA origination and servicing. Commercial FHA revenue represents gains from securitizing loans held for sale and net revenues earned on the servicing of loans sold. Gains on loans held for sale include the realized and unrealized gains and losses on sales of mortgage loans, as well as the changes in fair value of interest rate lock commitments and forward loan sale commitments. Revenue from servicing commercial FHA mortgages is recognized as earned based on the specific contractual terms of the underlying servicing agreements, along with amortization of and changes in impairment of mortgage servicing rights. Noninterest income from our commercial FHA business decreased \$2.7 million, or 44.9%, to \$3.3 million in the third quarter of 2016 and increased \$1.2 million, or 7.2%, to \$18.4 million for the first nine months of 2016. Love Funding generated gains on loans held for sale of \$3.8 million and a net servicing loss of \$0.5 million in the third quarter of 2016 compared to gains on loans held for sale of \$5.3 million and net servicing revenues of \$0.6 million in the third quarter of 2015. The \$1.6 million decrease in gains on loans held for sale was primarily due to a decrease in commercial FHA interest rate lock commitments to \$73.4 million in the third quarter of 2016 compared to \$196.0 million in the third quarter of 2015. The \$1.1 million decrease in net servicing revenue primarily resulted from \$1.1 million of impairment recorded against our commercial mortgage servicing rights during the third quarter of 2016.

For the first nine months of 2016, our commercial FHA business generated gains on loans held for sale of \$17.8 million and net servicing revenues of \$0.6 million compared to gains on loans held for sale of \$15.6 million and net servicing revenues of \$1.6 million in the first nine months of 2015. The \$2.2 million increase in gains on loans held for sale resulted primarily from an increase in commercial FHA interest rate lock commitments to \$581.8 million in the first nine months of 2016 compared to \$387.0 million in the first nine months of 2015. The \$1.0 million decrease in net servicing revenue primarily resulted from \$1.1 million of impairment recorded against our commercial mortgage servicing rights during the third quarter of 2016.

Residential mortgage banking revenue. Residential mortgage banking revenues are primarily generated from gains recognized on loans held for sale and fees earned from the servicing of residential loans sold to others. Gains on loans held for sale include the realized and unrealized gains and losses on sales of mortgage loans, as well as the changes in fair value of interest rate lock commitments and forward loan sale commitments. Revenue from servicing residential mortgages is recognized as earned based on the specific contractual terms of the underlying servicing agreements, along with amortization of and changes in impairment of mortgage servicing rights. Noninterest income from our residential mortgage banking business increased \$1.5 million, or 43.0%, to \$5.0 million in the third quarter of 2016 and decreased \$7.2 million, or 50.0%, to \$7.1 million for the first nine months of 2016. Our residential mortgage banking activities generated gains on loans held for sale of \$4.8 million and net servicing revenue of \$0.2 million in the third quarter of 2016 compared to gains on loans held for sale of \$3.7 million and a net servicing loss of \$0.2 million in the third quarter of 2015. The \$1.0 million increase in gains on loans held for sale was primarily due to a 32.5% increase in loan production during the third quarter of 2016. The \$0.5 million increase in net servicing revenue primarily resulted from the prior year third quarter reflecting \$0.8 million of impairment recorded against our residential mortgage servicing rights, offset in part by an increase in amortization of residential mortgage servicing rights.

For the first nine months of 2016, our residential mortgage banking activities generated gains on loans held for sale of \$11.0 million and a net servicing loss of \$3.9 million compared to gains on loans held for sale of \$13.5 million

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and net servicing revenue of \$0.8 million in the first nine months of 2015. The \$2.5 million decrease in gains on loans held for sale was primarily due to a 12.9% decline in loan production during the first nine months of 2016. The \$4.7 million decrease in net servicing revenue primarily resulted from \$5.0 million of impairment recorded against our residential mortgage servicing rights during the first nine months of 2016. The level of impairment recorded against our residential mortgage servicing rights during the first nine months of 2016 resulted primarily from the impact of decreases in long-term interest rates which led to increasing prepayment speed estimates in our determination of mortgage servicing asset market values. We recognized \$0.7 million of impairment in the first nine months of 2015.

FDIC loss-sharing expense. Fluctuations in FDIC loss-sharing expense are largely correlated to impairment charges or recoveries recorded on covered loans and other real estate owned acquired in previous FDIC-assisted transactions. We recorded FDIC loss-sharing expense of \$1.7 million during the nine months ended September 30, 2016 compared to \$0.4 million for the corresponding nine month period in 2015. This increase in FDIC loss-sharing expense resulted primarily from us reimbursing the FDIC \$1.5 million for 80% of covered losses paid to us previously on a covered loan that was paid in full during the second quarter of 2016 (see “Significant Transactions – *Purchased Credit-Impaired Loans*” above). For the third quarter of 2016, FDIC loss-sharing expense was zero compared to \$0.1 million for the third quarter of 2015.

Other-than-temporary impairment on investment securities. During the first quarter of 2016, we concluded that three covered non-agency mortgage-backed securities had OTTI of \$0.8 million due to changes in expected cash flows. These amounts were recognized as losses in the consolidated statement of income for the first quarter of 2016. We determined in the second and third quarters of 2016 there were no additional investment securities that were other-than-temporarily impaired. This resulted in zero and \$0.8 million of OTTI on investment securities recognized for the three and nine months ended September 30, 2016, respectively.

For the three months ended September 30, 2015, we determined that two covered non-agency mortgage-backed securities had OTTI of \$0.3 million, both due to changes in expected cash flows. These amounts were recognized as losses in the consolidated statement of income for the three months ended September 30, 2015.

During the nine months ended September 30, 2015, we determined, due to changes in expected cash flows, that three covered non-agency mortgage-backed securities had OTTI of \$0.5 million. These amounts were recognized as losses in the consolidated statement of income for the nine months ended September 30, 2015.

Other income. Other income totaled \$2.3 million and \$5.5 million for the three and nine months ended September 30, 2016, respectively, compared to \$1.2 million and \$3.2 million for the corresponding three and nine month periods in the prior year, respectively. These increases in other income for both the three- and nine-month periods of 2016 were partially due to an increase in income earned on bank-owned life insurance (“BOLI”). The Company purchased \$20.0 million of additional BOLI policies in both the second quarter of 2015 and the second quarter of 2016. During the third quarter of 2016, the Company recognized \$0.7 million of death benefits in other income due to the passing of an employee covered by BOLI. Other income was also impacted by the comparable 2015 periods including amortization expense related to our FDIC indemnification asset that was fully amortized by the end of 2015. Additionally, during the nine months ended September 30, 2016, other noninterest income benefited from the second quarter 2016 reversal of the remaining \$0.4 million contingent consideration accrual that was established in conjunction with the Heartland Bank acquisition based on Love Funding reaching a certain level of net income for the two-year period ending December 31, 2016. The Company’s quarterly assessment of this liability determined that payment of any contingent consideration amount would not occur.

Noninterest Expense. Noninterest expense totaled \$28.7 million in the third quarter of 2016 compared to \$27.8 million in the third quarter of 2015. For the nine months ended September 30, 2016, noninterest expense decreased \$2.9

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million, or 3.2%, to \$87.2 million. The following tables set forth the major components of noninterest expense for the three and nine months ended September 30, 2016 and 2015:

(dollars in thousands)	For the Three Months Ended		
	September 30,		Increase (decrease)
	2016	2015	
<i>Noninterest expense:</i>			
Salaries and employee benefits	\$ 16,568	\$ 14,932	\$ 1,636
Occupancy and equipment	3,271	3,114	157
Data processing	2,586	2,541	45
FDIC insurance	388	371	17
Professional	1,877	2,075	(198)
Marketing	717	855	(138)
Communications	546	506	40
Loan expense	314	789	(475)
Other real estate owned	179	203	(24)
Amortization of intangible assets	514	597	(83)
Other	1,703	1,840	(137)
Total noninterest expense	<u>\$ 28,663</u>	<u>\$ 27,823</u>	<u>\$ 840</u>

(dollars in thousands)	For the Nine Months Ended		
	September 30,		Increase (decrease)
	2016	2015	
<i>Noninterest expense:</i>			
Salaries and employee benefits	\$ 48,967	\$ 49,588	\$ (621)
Occupancy and equipment	9,815	9,727	88
Data processing	7,830	7,651	179
FDIC insurance	1,350	1,514	(164)
Professional	5,151	6,608	(1,457)
Marketing	2,009	2,247	(238)
Communications	1,609	1,791	(182)
Loan expense	1,351	2,349	(998)
Other real estate owned	748	660	88
Amortization of intangible assets	1,613	1,863	(250)
Other	6,762	6,073	689
Total noninterest expense	<u>\$ 87,205</u>	<u>\$ 90,071</u>	<u>\$ (2,866)</u>

Salaries and employee benefits. Salaries and employee benefits expense increased \$1.6 million, or 11.0%, to \$16.6 million for the third quarter of 2016. This increase was primarily attributable to an increase in the level of full-time equivalent employees, salary increases that took effect at the beginning of the second quarter of 2016, greater medical insurance costs and an increase in annual bonus expense.

Salaries and employee benefits expense decreased \$0.6 million, or 1.3%, to \$49.0 million for the first nine months of 2016. This decrease resulted primarily from the comparable 2015 period including severance accruals for certain Heartland Bank employees who were terminated. This decrease was also impacted by a decline in annual bonus expense.

Professional. Professional fees decreased \$0.2 million, or 9.5%, to \$1.9 million for the third quarter of 2016 and \$1.5 million, or 22.0%, to \$5.2 million for the first nine months of 2016. These decreases were primarily due to the first nine months of 2015 including nonrecurring consulting expenses and legal fees associated with integrating the Heartland Bank entities acquired at the end of 2014.

Loan expense. Loan expense totaled \$0.3 million and \$1.4 million for the three and nine months ended September 30, 2016, respectively, compared to \$0.8 million and \$2.3 million for the three and nine months ended September 30, 2015, respectively. Loan expense includes costs related to collateral protection and collection activities. These decreases were primarily the result of additional costs incurred in 2015 related to integrating the Heartland Bank entities acquired at the end of 2014.

Other noninterest expense. Other noninterest expense totaled \$1.7 million and \$6.8 million for the three and nine months ended September 30, 2016, respectively, compared to \$1.8 million and \$6.1 million for the three and nine

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months ended September 30, 2015, respectively. The \$0.7 million increase for the first nine months of 2016 primarily resulted from a \$0.5 million write-off of discount associated with the \$8.0 million subordinated debt payoff in the second quarter of 2016. This increase was also impacted by increased losses associated with debit cardholder disputes.

Income Tax Expense. Income tax expense was \$4.1 million and \$10.6 million for the three and nine months ended September 30, 2016, respectively, compared to \$1.9 million and \$8.3 million for the three and nine months ended September 30, 2015, respectively. Effective tax rates were 33.8% and 34.6% for the three and nine months ended September 30, 2016, respectively, compared to 35.8% and 33.1% for the three and nine months ended September 30, 2015, respectively. The major differences between the effective tax rates applied to our income and the federal statutory tax rates are caused by interest on tax-exempt securities and loans. The higher effective tax rate for the first nine months of 2016 was primarily due to income before taxes growing without a corresponding increase in tax exempt items.

Financial Condition

Assets. Total assets increased \$362.9 million, or 12.6%, to \$3.2 billion at September 30, 2016 as compared to December 31, 2015. This increase primarily resulted from loan growth of \$317.2 million that was primarily funded by a \$228.1 million increase in short-term borrowings and FHLB advances and a portion of the \$71.5 million of net proceeds from our initial public offering.

Loans. The loan portfolio is the largest category of our assets. At September 30, 2016, total loans, net of allowance for loan losses, were \$2.3 billion. The following table presents the balance and associated percentage of each major category in our loan portfolio at September 30, 2016 and December 31, 2015:

(dollars in thousands)	September 30, 2016		December 31, 2015	
	Book Value	%	Book Value	%
Loans:				
Commercial	\$ 545,069	23.6 %	\$ 499,573	25.0 %
Commercial real estate	956,298	41.3	876,784	43.9
Construction and land development	163,900	7.1	150,266	7.6
Total commercial loans	1,665,267		1,526,623	
Residential real estate	216,935	9.4	163,224	8.2
Consumer	248,131	10.7	161,512	8.1
Lease financing	182,445	7.9	144,230	7.2
Total loans, gross	2,312,778		1,995,589	
Allowance for loan losses	(15,559)	0.7	(15,988)	0.8
Total loans, net	\$ 2,297,219		\$ 1,979,601	
Covered loans	\$ 786	0.0	\$ 3,629	0.2
PCI loans	29,424	1.3	38,477	1.9

Loans increased \$317.2 million, or 15.9%, to \$2.3 billion at September 30, 2016 as compared to December 31, 2015. This increase primarily resulted from growth in commercial real estate loans, residential real estate loans, consumer loans and lease financing receivables. Included in commercial loans was a \$73.2 million advance to a customer who originates commercial FHA loans. This advance occurred late in the third quarter of 2016 and was repaid subsequent to September 30, 2016 after the FHA loans originated by the customer were sold into the secondary market.

The \$2.8 million decrease in covered loans was primarily attributable to the loss-sharing agreement for commercial and commercial real estate loans associated with a 2010 acquisition expiring on January 1, 2016. Coverage for residential loans, which totaled \$0.8 million at September 30, 2016, concluded on October 3, 2016 when the Company entered into an agreement with the FDIC to terminate its existing loss share agreements. The \$9.1 million decrease in PCI loans was primarily due to repayments and payoffs of PCI loans.

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The following table shows covered and non-covered loans by non-PCI and PCI loan category and the related allowance as of September 30, 2016 and December 31, 2015:

(dollars in thousands)	September 30, 2016			December 31, 2015		
	Non-PCI Loans	PCI Loans	Total	Non-PCI Loans	PCI Loans	Total
Covered loans:						
Commercial	\$ —	\$ —	\$ —	\$ 378	\$ 1,067	\$ 1,445
Commercial real estate	—	—	—	876	318	1,194
Construction and land development	—	—	—	—	—	—
Residential real estate	688	98	786	715	275	990
Consumer	—	—	—	—	—	—
Lease financing	—	—	—	—	—	—
Total covered loans	688	98	786	1,969	1,660	3,629
Non-covered loans:						
Commercial	541,452	3,617	545,069	493,067	5,061	498,128
Commercial real estate	948,831	7,467	956,298	861,868	13,722	875,590
Construction and land development	152,423	11,477	163,900	140,207	10,059	150,266
Residential real estate	209,679	6,470	216,149	154,551	7,683	162,234
Consumer	247,836	295	248,131	161,220	292	161,512
Lease financing	182,445	—	182,445	144,230	—	144,230
Total non-covered loans	2,282,666	29,326	2,311,992	1,955,143	36,817	1,991,960
Total loans, gross	2,283,354	29,424	2,312,778	1,957,112	38,477	1,995,589
Allowance for loan losses	(14,229)	(1,330)	(15,559)	(14,093)	(1,895)	(15,988)
Total loans, net	\$ 2,269,125	\$ 28,094	\$ 2,297,219	\$ 1,943,019	\$ 36,582	\$ 1,979,601
Nonperforming loans	\$ 29,926	—	\$ 29,926	\$ 24,891	—	\$ 24,891
Nonperforming loans to total loans	1.31 %	—	1.29 %	1.27 %	—	1.25 %
Allowance for loan losses to total loans	0.62 %	4.52 %	0.67 %	0.72 %	4.93 %	0.80 %

The following table shows the contractual maturities of our loan portfolio and the distribution between fixed and adjustable interest rate loans at September 30, 2016:

(dollars in thousands)	September 30, 2016						Total
	Within One Year		One Year to Five Years		After Five Years		
	Fixed Rate	Adjustable Rate	Fixed Rate	Adjustable Rate	Fixed Rate	Adjustable Rate	
Loans:							
Commercial	\$ 53,717	\$ 195,989	\$ 111,149	\$ 110,974	\$ 62,745	\$ 10,495	\$ 545,069
Commercial real estate	94,643	46,008	450,096	141,131	79,928	144,492	956,298
Construction and land development	34,318	59,451	16,760	40,232	1,862	11,277	163,900
Total commercial loans	182,678	301,448	578,005	292,337	144,535	166,264	1,665,267
Residential real estate	4,162	7,975	13,457	33,042	79,039	79,260	216,935
Consumer	8,045	4,405	59,251	24,520	150,402	1,508	248,131
Lease financing	6,045	—	174,743	—	1,657	—	182,445
Total loans	\$ 200,930	\$ 313,828	\$ 825,456	\$ 349,899	\$ 375,633	\$ 247,032	\$ 2,312,778

The principal categories of our loan portfolio are discussed below:

Commercial loans. We provide a mix of variable and fixed rate commercial loans. The loans are typically made to small- and medium-sized manufacturing, wholesale, retail and service businesses for working capital needs, business expansions and farm operations. Commercial loans generally include lines of credit and loans with maturities of five years or less. The loans are generally made with business operations as the primary source of repayment, but may also include collateralization by inventory, accounts receivable and equipment, and generally include personal guarantees.

Commercial loans increased \$45.5 million, or 9.1%, to \$545.1 million at September 30, 2016 as compared to December 31, 2015. Excluding the \$73.2 million of advances made to a commercial FHA lender discussed above, commercial loans decreased \$27.7 million, or 5.5%. This decrease resulted primarily from loan repayments of commercial loans exceeding new originations.

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Commercial real estate loans. Commercial real estate loans increased \$79.5 million, or 9.1%, to \$956.3 million at September 30, 2016 as compared to December 31, 2015. This increase resulted from organic loan growth during the first nine months of 2016 exceeding loan repayments. Originations included 14 new loans ranging in size from \$1.6 million to \$12.0 million.

Construction and land development loans. Our construction and land development loans are comprised of residential construction, commercial construction and land acquisition and development loans. Interest reserves are generally established on real estate construction loans. As of September 30, 2016, our construction and land development loan portfolio was divided among the foregoing categories as follows: \$9.3 million residential construction; \$145.4 million commercial construction; and \$9.2 million land acquisition and development.

Construction and land development loans increased \$13.6 million, or 9.1%, to \$163.9 million at September 30, 2016 as compared to December 31, 2015. This increase in construction and land development loans was primarily due to construction loan originations exceeding repayments and transfers to permanent financing.

Residential real estate loans. Residential real estate loans increased \$53.7 million, or 32.9%, to \$216.9 million at September 30, 2016 as compared to December 31, 2015. This increase was primarily due to a new lending program implemented in the second quarter of 2016 that targeted loans to doctors and generated \$68.8 million in new residential real estate loans since implementation. Included within residential real estate loans were home equity loans which decreased \$7.8 million, or 11.3%, to \$61.3 million at September 30, 2016 as compared to December 31, 2015.

Consumer loans. Our consumer loans include direct personal loans, indirect automobile loans, lines of credit and installment loans originated through home improvement specialty retailers and contractors. Personal loans are generally secured by automobiles, boats and other types of personal property and are made on an installment basis.

Consumer loans increased \$86.6 million, or 53.6%, to \$248.1 million at September 30, 2016 as compared to December 31, 2015. This increase reflected the purchase of \$48.7 million of installment loans originated by another bank through home improvement specialty retailers and contractors, combined with organic growth of installment loans originated by us through home improvement specialty retailers and contractors. This increase also reflected the purchase of an \$11.8 million portfolio of indirect auto loans.

Lease financing. Business Credit, our custom leasing subsidiary located in Denver, Colorado, provides indirect financing leases to varying types of small businesses for purchases of business equipment and software. All indirect financing leases require monthly payments, and the weighted average maturity of our leases is less than four years. Lease financing receivables increased \$38.2 million, or 26.5%, to \$182.4 million at September 30, 2016 as compared to December 31, 2015 as continued growth in new lease volume exceeded repayments.

Loan Quality

We use what we believe is a comprehensive methodology to monitor credit quality and prudently manage credit concentration within our loan portfolio. Our underwriting policies and practices govern the risk profile and credit and geographic concentration for our loan portfolio. We also have what we believe to be a comprehensive methodology to monitor these credit quality standards, including a risk classification system that identifies potential problem loans based on risk characteristics by loan type as well as the early identification of deterioration at the individual loan level. In addition to our allowance for loan losses, our purchase discounts on acquired loans provide additional protections against credit losses.

Discounts on PCI Loans. PCI loans are loans that have evidence of credit deterioration since origination and for which it is probable at the date of acquisition that we will not collect all contractually required principal and interest payments. These loans are recorded at estimated fair value on their purchase date without a carryover of the related allowance for loan losses. At September 30, 2016 and December 31, 2015, we had PCI loans totaling \$29.4 million and \$38.5 million, respectively.

The difference between contractually required payments due and the cash flows expected to be collected, considering the impact of prepayments, is referred to as the nonaccretable difference. The nonaccretable difference, which is neither accreted into income nor recorded on our consolidated balance sheet, reflects estimated future credit losses expected to be incurred over the life of the loans. The excess of cash flows expected to be collected over the estimated fair value of PCI loans is referred to as the accretable yield. This amount is not recorded on our consolidated

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balance sheet, but is accreted into interest income over the remaining life of the loans, or pool of loans, using the effective yield method. The outstanding customer balance for PCI loans totaled \$37.1 million and \$44.5 million as of September 30, 2016 and December 31, 2015, respectively.

Subsequent to acquisition, we periodically evaluate our estimates of cash flows expected to be collected. These evaluations, performed quarterly, require the continued use of key assumptions and estimates, similar to the initial estimate of fair value. Subsequent changes in the estimated cash flows expected to be collected may result in changes in the accretible yield and nonaccretible difference or reclassifications between accretible yield and the nonaccretible difference. Decreases in expected cash flows due to further credit deterioration will result in an impairment charge to the provision for loan losses, resulting in an increase to the allowance for loan losses and a reclassification from accretible yield to nonaccretible difference. Increases in expected cash flows due to credit improvements will result in an increase in the accretible yield through a reclassification from the nonaccretible difference or as a reduction in the allowance for loan losses to the extent established on specific pools subsequent to acquisition. The adjusted accretible yield is recognized in interest income over the remaining life of the loan, or pool of loans.

The following table shows changes in the accretible yield for PCI loans for the three and nine months ended September 30, 2016 and 2015:

(dollars in thousands)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Balance, beginning of period	\$ 6,729	\$ 14,237	\$ 10,526	\$ 16,198
Accretion	(1,810)	(1,006)	(7,066)	(3,013)
Other adjustments (including maturities, charge-offs, and impact of changes in timing of expected cash flows)	179	—	(96)	67
Reclassification from non-accretible	2,568	325	4,302	304
Balance, end of period	<u>\$ 7,666</u>	<u>\$ 13,556</u>	<u>\$ 7,666</u>	<u>\$ 13,556</u>

As of September 30, 2016, the balance of accretible discounts on our PCI loan portfolio was \$7.7 million compared to \$10.5 million at December 31, 2015. We may not accrete the full amount of these discounts into interest income in future periods if the assets to which these discounts are applied do not perform according to our current expectations.

We have also recorded accretible discounts in purchase accounting for loans that are not considered PCI loans. Similar to the way in which we employ the fair value methodology for PCI loans, we consider expected prepayments and estimate the amount and timing of undiscounted cash flows in order to determine the accretible discount for non-PCI loans.

Analysis of the Allowance for Loan Losses. The following table allocates the allowance for loan losses, or the allowance, by loan category:

(dollars in thousands)	September 30, 2016		December 31, 2015	
	Book Value	% ⁽¹⁾	Book Value	% ⁽¹⁾
Loans:				
Commercial	\$ 7,187	1.32 %	\$ 6,917	1.38 %
Commercial real estate	3,414	0.36	5,179	0.59
Construction and land development	310	0.19	435	0.29
Total commercial loans	<u>10,911</u>	0.66	<u>12,531</u>	0.82
Residential real estate	2,683	1.24	2,120	1.30
Consumer	1,082	0.44	749	0.46
Lease financing	883	0.48	588	0.41
Total allowance for loan losses	<u>\$ 15,559</u>	0.67	<u>\$ 15,988</u>	0.80

(1) Represents the percentage of the allowance to total loans in the respective category.

The allowance and the balance of nonaccretible discounts represent our estimate of probable and reasonably estimable credit losses inherent in loans held for investment as of the respective balance sheet date. We assess the appropriateness of our allowance for non-PCI loans separately from our allowance for PCI loans.

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The allowance for loan losses was \$15.6 million at September 30, 2016 compared to \$16.0 million at December 31, 2015. The \$0.4 million decrease at September 30, 2016 compared to December 31, 2015 was mainly attributable to net charge-offs of \$3.6 million, offset in part by a provision for loan losses of \$3.1 million for the first nine months of 2016. The provision for loan losses for the first nine months of 2016 was favorably impacted by a \$0.8 million credit recorded against the provision for PCI loans related to a covered loan that was paid in full during the second quarter of 2016 (see “Significant Transactions – Purchased Credit-Impaired Loans” above).

Individual loans considered to be uncollectible are charged off against the allowance. Factors used in determining the amount and timing of charge-offs on loans include consideration of the loan type, length of delinquency, sufficiency of collateral value, lien priority and the overall financial condition of the borrower. Collateral value is determined using updated appraisals and/or other market comparable information. Charge-offs are generally taken on loans once the impairment is determined to be other-than-temporary. Recoveries on loans previously charged off are added to the allowance. Net charge-offs to average loans were 0.23% and 1.57% for the nine months ended September 30, 2016 and 2015, respectively.

Allowance for non-PCI loans. Our methodology for assessing the appropriateness of the allowance for non-PCI loans includes a general allowance for performing loans, which are grouped based on similar characteristics, and a specific allowance for individual impaired loans or loans considered by management to be in a high risk category. General allowances are established based on a number of factors, including historical loss rates, an assessment of portfolio trends and conditions, accrual status and economic conditions.

For commercial and commercial real estate loans, a specific allowance may be assigned to individual loans based on an impairment analysis. Loans are considered impaired when it is probable that we will be unable to collect all amounts due according to the contractual terms of the loan agreement. The amount of impairment is based on an analysis of the most probable source of repayment, including the present value of the loan's expected future cash flows and the estimated market value or the fair value of the underlying collateral. Interest income on impaired loans is accrued as earned, unless the loan is placed on nonaccrual status.

Allowance for PCI loans. PCI loans are recorded at their estimated fair value at the date of acquisition, with the estimated fair value including a component for estimated credit losses. An allowance related to PCI loans may be recorded subsequent to acquisition if a PCI loan pool experiences a decrease in expected cash flows as compared to the expected cash flows projected in the previous quarter. Loans considered to be uncollectible are initially charged off against the specific loan pool's non-accretable difference. When the pool's non-accretable difference has been fully utilized, uncollectible amounts are charged off against the corresponding allowance. The following table shows our allowance by loan portfolio and by non-PCI and PCI loans as of September 30, 2016 and December 31, 2015:

(dollars in thousands)	September 30, 2016			December 31, 2015		
	Non-PCI Loans	PCI Loans	Total	Non-PCI Loans	PCI Loans	Total
Loans:						
Commercial	\$ 6,531	\$ 656	\$ 7,187	\$ 6,542	\$ 375	\$ 6,917
Commercial real estate	3,186	228	3,414	4,176	1,003	5,179
Construction and land development	310	—	310	419	16	435
Total commercial loans	10,027	884	10,911	11,137	1,394	12,531
Residential real estate	2,260	423	2,683	1,626	494	2,120
Consumer	1,059	23	1,082	742	7	749
Lease financing	883	—	883	588	—	588
Total allowance for loan losses	\$ 14,229	\$ 1,330	\$ 15,559	\$ 14,093	\$ 1,895	\$ 15,988

Provision for Loan Losses. In determining the allowance and the related provision for loan losses, we consider three principal elements: (i) valuation allowances based upon probable losses identified during the review of impaired commercial, commercial real estate, and construction and land development loans, (ii) allocations, by loan classes, on loan portfolios based on historical loan loss experience and qualitative factors, and (iii) valuation allowances on PCI loan pools based on decreases in expected cash flows. Provisions for loan losses are charged to operations to adjust the total allowance to a level deemed appropriate by us.

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The following table provides an analysis of the allowance for loan losses, provision for loan losses and net charge-offs for the three and nine months ended September 30, 2016 and 2015:

(dollars in thousands)	As of and for the Three Months Ended September 30,		As of and for the Nine Months Ended September 30,	
	2016	2015	2016	2015
Balance, beginning of period	\$ 14,752	\$ 16,206	\$ 15,988	\$ 12,300
Charge-offs:				
Commercial	251	7,486	2,513	7,587
Commercial real estate	214	12	461	307
Construction and land development	1	23	1	39
Residential real estate	153	318	454	665
Consumer	91	110	225	237
Lease financing	154	—	632	110
Total charge-offs	864	7,949	4,286	8,945
Recoveries:				
Commercial	36	56	164	1,141
Commercial real estate	129	57	216	303
Construction and land development	13	8	30	25
Residential real estate	32	52	131	121
Consumer	20	25	79	92
Lease financing	49	3	91	45
Total recoveries	279	201	711	1,727
Net charge-offs	585	7,748	3,575	7,218
Provision for loan losses	1,392	6,699	3,146	10,075
Balance, end of period	\$ 15,559	\$ 15,157	\$ 15,559	\$ 15,157
Gross loans, end of period	\$2,312,778	\$1,972,844	\$2,312,778	\$1,972,844
Average loans ⁽¹⁾	\$2,177,518	\$1,954,441	\$2,091,633	\$1,873,993
Net charge-offs to average loans	0.11 %	1.57 %	0.23 %	0.51 %
Allowance to total loans	0.67 %	0.77 %	0.67 %	0.77 %

(1) Excludes loans held for sale.

Problem Loans. The following table sets forth our nonperforming assets by asset categories as of the dates indicated. Nonperforming loans include nonaccrual loans, loans past due 90 days or more and still accruing interest and loans modified under troubled debt restructurings. The balances of nonperforming loans reflect the net investment in these assets, including deductions for purchase discounts. PCI loans are excluded from nonperforming status because we expect to fully collect their new carrying values, which reflect significant purchase discounts. If our expectation of reasonably estimable future cash flows from PCI loans deteriorates, the loans may be classified as nonaccrual loans and interest income will not be recognized until the timing and amount of future cash flows can be reasonably estimated.

(dollars in thousands)	September 30, 2016	December 31, 2015
Nonperforming loans:		
Commercial	\$ 6,519	\$ 6,570
Commercial real estate	17,948	13,717
Construction and land development	64	—
Residential real estate	4,466	4,155
Consumer	202	51
Lease financing	727	398
Total nonperforming loans	29,926	24,891
Other real estate owned, non-covered/non-guaranteed	4,378	4,315
Nonperforming assets	\$ 34,304	\$ 29,206
Nonperforming loans to total loans	1.29 %	1.25 %
Nonperforming assets to total assets	1.06 %	1.01 %

The increase in nonperforming loans at September 30, 2016 was primarily due to a \$10.0 million commercial real estate loan that was classified as a TDR during the third quarter of 2016. This increase was offset in part by \$4.8 million of payments received on two nonperforming loans during the first quarter of 2016, which included \$2.9 million for a nonaccrual loan acquired from Heartland Bank. Near the end of the first quarter of 2016, we recorded a \$1.6 million charge-off for the remaining amount of this nonaccrual loan acquired from Heartland Bank.

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We did not recognize any interest income on nonaccrual loans during the nine months ended September 30, 2016 and 2015 while the loans were in nonaccrual status. Additional interest income that we would have recognized on these loans had they been current in accordance with their original terms was \$0.5 million and \$0.7 million during the nine months ended September 30, 2016 and 2015, respectively. We recognized interest income on commercial and commercial real estate loans modified under troubled debt restructurings of \$0.2 million and \$0.3 million during the nine months ended September 30, 2016 and 2015, respectively.

We use a risk grading system to categorize and determine the credit risk of our loans. Potential problem loans include loans with a risk grade of 7, which are "special mention," and loans with a risk grade of 8, which are "substandard" loans that are not considered to be impaired. These loans generally require more frequent loan officer contact and receipt of financial data to closely monitor borrower performance. Potential problem loans are managed and monitored regularly through a number of processes, procedures and committees, including oversight by a loan administration committee comprised of executive officers and other members of the Bank's senior management team. The following table presents the recorded investment of potential problem commercial loans (excluding PCI loans) by loan category at the dates indicated:

(in thousands)	Commercial		Commercial Real Estate		Construction & Land Development		Total
	Risk Category		Risk Category		Risk Category		
	7	8 ⁽¹⁾	7	8 ⁽¹⁾	7	8 ⁽¹⁾	
September 30, 2016	\$ 5,293	\$ 10,518	\$ 9,353	\$ 10,866	\$ —	\$ 450	\$ 36,480
December 31, 2015	15,884	3,370	23,679	8,103	540	—	51,576

(1) Includes only those 8-rated loans that are not included in nonperforming loans.

Investment Securities. Our investment strategy aims to maximize earnings while maintaining liquidity in securities with minimal credit risk. The types and maturities of securities purchased are primarily based on our current and projected liquidity and interest rate sensitivity positions.

The following table sets forth the book value and percentage of each category of investment securities at September 30, 2016 and December 31, 2015. The book value for investment securities classified as available for sale is equal to fair market value and the book value for investment securities classified as held to maturity is equal to amortized cost.

(dollars in thousands)	September 30, 2016		December 31, 2015	
	Book Value	% of Total	Book Value	% of Total
<i>Investment securities, available for sale, at fair value</i>				
U.S. Treasury securities	\$ 35,506	10.6 %	\$ 48,302	14.9 %
Government sponsored entity debt securities	8,990	2.7	9,454	2.9
Agency mortgage-backed securities	68,656	20.5	67,527	20.8
Non-agency mortgage-backed securities	1	—	2	—
Covered non-agency mortgage-backed securities ⁽¹⁾	72,093	21.5	75,979	23.5
State and municipal securities	21,980	6.6	15,494	4.8
Corporate securities	44,986	13.4	19,869	6.1
Total investment securities, available for sale, at fair value	252,212	75.3	236,627	73.0
<i>Investment securities, held to maturity, at amortized cost</i>				
State and municipal securities	82,941	24.7	87,521	27.0
Total investment securities	\$ 335,153	100.0 %	\$ 324,148	100.0 %

(1) All covered non-agency mortgage-backed securities are covered under the loss-sharing agreement we entered into with the FDIC in connection with our 2009 acquisition. This agreement had a seven year term that expired on July 1, 2016 with respect to covered losses. On October 3, 2016, the Company entered into an agreement with the FDIC to terminate its existing loss share agreements. None of our other investment securities are covered under a loss-sharing agreement with the FDIC.

Our covered non-agency mortgage-backed securities ("covered CMOs") were covered under a loss-sharing agreement with the FDIC pursuant to which the FDIC agreed to reimburse us for 80% of the first \$167.0 million of net losses (when aggregated with losses on the other covered assets) and 95% of net losses exceeding \$167.0 million. The loss-sharing agreement for the covered CMOs had a seven-year term that expired on July 1, 2016. In accordance with this agreement, we submitted claims of \$48.1 million and received payments from the FDIC totaling \$38.4 million.

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The predominant form of collateral underlying the covered CMOs is fixed-rate, first lien residential mortgages of both conforming and jumbo mortgage size with both traditional and nontraditional underwriting qualities (e.g., jumbo, conforming Alt-A and jumbo Alt-A, which includes reduced documentation types). All of our covered CMOs are senior securities that rank ahead of subordinated tranches intended to be in a first-loss position with respect to the collateral pool. The majority of these securities were originated from 2003 through 2007. At September 30, 2016, our covered CMOs had an amortized cost of \$58.4 million with a fair value of \$72.1 million and a net unrealized gain of \$13.7 million. Our investment in covered CMOs decreased from \$76.0 million at December 31, 2015 to \$72.1 million at September 30, 2016 due to payments received on the securities and other-than-temporary impairment losses recognized during the first quarter of 2016 exceeding increases in net unrealized gains. Subsequent to entering into the loss-share termination agreement with the FDIC in October 2016, the Company sold the previously covered CMOs and realized a gain of \$14.3 million.

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The following table sets forth the book value, maturities and weighted average yields for our investment portfolio at September 30, 2016. The book value for investment securities classified as available for sale is equal to fair market value and the book value for investment securities classified as held to maturity is equal to amortized cost.

	September 30, 2016		
	Book Value	% of Total Investment Securities	Weighted Average Yield
(dollars in thousands)			
Investment securities, available for sale			
<i>U.S. Treasury securities:</i>			
Maturing within one year	\$ 32,505	9.7 %	0.6 %
Maturing in one to five years	3,001	0.9	0.8
Maturing in five to ten years	—	0.0	0.0
Maturing after ten years	—	0.0	0.0
Total U.S. Treasury securities	\$ 35,506	10.6 %	0.6 %
<i>Government sponsored entity debt securities:</i>			
Maturing within one year	\$ 1,008	0.3 %	0.8 %
Maturing in one to five years	1,005	0.3	1.6
Maturing in five to ten years	6,278	1.9	2.5
Maturing after ten years	699	0.2	2.5
Total U.S. government securities	\$ 8,990	2.7 %	2.2 %
<i>Agency mortgage-backed securities ⁽¹⁾:</i>			
Maturing within one year	\$ 2,635	0.8 %	2.4 %
Maturing in one to five years	48,308	14.4	2.0
Maturing in five to ten years	10,145	3.0	2.5
Maturing after ten years	7,568	2.3	2.9
Total agency mortgage-backed securities	\$ 68,656	20.5 %	2.2 %
<i>Non-agency mortgage-backed securities ⁽¹⁾:</i>			
Maturing within one year	\$ —	0.0 %	0.0 %
Maturing in one to five years	—	0.0	0.0
Maturing in five to ten years	—	0.0	0.0
Maturing after ten years	1	0.0	6.5
Total non-agency mortgage-backed securities	\$ 1	0.0 %	6.5 %
<i>Covered non-agency mortgage-backed securities ⁽¹⁾⁽²⁾:</i>			
Maturing within one year	\$ 1,263	0.4 %	7.0 %
Maturing in one to five years	52,719	15.7	13.2
Maturing in five to ten years	13,140	3.9	13.7
Maturing after ten years	4,971	1.5	12.8
Total covered non-agency mortgage-backed securities	\$ 72,093	21.5 %	13.1 %
<i>State and municipal securities ⁽²⁾:</i>			
Maturing within one year	\$ 3,027	0.9 %	2.0 %
Maturing in one to five years	7,663	2.3	2.0
Maturing in five to ten years	9,786	2.9	3.1
Maturing after ten years	1,504	0.5	3.8
Total state and municipal securities	\$ 21,980	6.6 %	2.6 %
<i>Corporate securities:</i>			
Maturing within one year	\$ 6,012	1.8 %	1.9 %
Maturing in one to five years	7,673	2.3	3.8
Maturing in five to ten years	28,781	8.6	4.6
Maturing after ten years	2,520	0.7	4.8
Total corporate securities	\$ 44,986	13.4 %	4.1 %
Total investment securities, available for sale	\$ 252,212	75.3 %	5.1 %
Investment securities, held to maturity			
<i>State and municipal securities ⁽²⁾:</i>			
Maturing within one year	\$ 1,734	0.5 %	4.7 %
Maturing in one to five years	17,166	5.1	5.6
Maturing in five to ten years	43,234	12.9	6.5
Maturing after ten years	20,807	6.2	6.0
Total state and municipal securities	\$ 82,941	24.7 %	6.1 %
Total investment securities	\$ 335,153	100.0 %	5.3 %

(1) All covered non-agency mortgage-backed securities are covered under the loss-sharing agreement we entered into with the FDIC in connection with our 2009 acquisition. This agreement had a seven year term that expired on July 1, 2016 with respect to covered losses. On October 3, 2016, the Company entered into an agreement with the FDIC to terminate its existing loss share agreements. None of our other investment securities are covered under a loss-sharing agreement with the FDIC.

(2) Weighted average yield for tax-exempt securities are presented on a tax-equivalent basis assuming a federal income tax rate of 35%.

(3) The maturities of agency, non-agency and covered non-agency mortgage-backed securities are based on expected maturities. Expected maturities may differ from contractual maturities in mortgage-backed securities because the mortgages underlying the securities may be prepaid without any penalties. The maturities of all other available-for-sale investment securities are based on final contractual maturity.

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Declines in the fair value of available-for-sale investment securities are recorded as either temporary impairment or OTTI. OTTI is recorded when the fair value of an available-for-sale security is less than historical cost, and it is probable that all contractual cash flows will not be collected. OTTI is recorded to noninterest income and, therefore, results in a negative impact to our net income. An increase in the value of an OTTI security is not recorded as a recovery but as additional interest income over the remaining life of the security. During the first quarter of 2016, we concluded that three covered non-agency mortgage-backed securities had OTTI of \$0.8 million due to changes in expected cash flows. These amounts were recognized as losses in the consolidated statement of income for the first quarter of 2016. We determined in both the second and third quarters of 2016 there were no additional investment securities that were other-than-temporarily impaired. In the first quarter of 2015, we determined, due to changes in expected cash flows, that one covered non-agency mortgage-backed security had OTTI of \$0.2 million. This amount was recognized as a loss in the consolidated statement of income for the first quarter of 2015. There were no investment securities considered by us to be other-than-temporarily impaired in the second quarter of 2015. For the three months ended September 30, 2015, we determined that two covered non-agency mortgage-backed securities had OTTI of \$0.3 million, both due to changes in expected cash flows. These amounts were recognized as losses in the consolidated statement of income for the three months ended September 30, 2015.

The table below presents the credit ratings at September 30, 2016 at fair value for our investment securities classified as available for sale and amortized cost for investment securities classified as held to maturity.

(dollars in thousands)	September 30, 2016								
	Amortized Cost	Estimated Fair Value	Average Credit Rating						
			AAA	AA+/-	A+/-	BBB+/-	<BBB-	Not Rated	
<i>Investment securities available for sale:</i>									
U.S. Treasury securities	\$ 35,499	\$ 35,506	\$ —	\$ 35,506	\$ —	\$ —	\$ —	\$ —	\$ —
Government sponsored entity debt securities	8,788	8,990	—	8,990	—	—	—	—	—
Agency mortgage-backed securities	67,536	68,656	612	68,044	—	—	—	—	—
Non-covered non-agency mortgage-backed securities	1	1	—	—	—	—	—	—	1
Covered non-agency mortgage-backed securities ⁽¹⁾	58,376	72,093	—	—	1,263	—	68,995	1,835	—
State and municipal securities	21,724	21,980	4,552	13,040	2,531	—	—	1,857	—
Corporate securities	44,853	44,986	—	2,007	11,128	24,275	—	—	7,576
Total investment securities, available for sale, at fair value	236,777	252,212	5,164	127,587	14,922	24,275	68,995	11,269	—
<i>Investment securities held to maturity:</i>									
State and municipal securities	82,941	88,590	6,661	46,850	18,779	—	710	15,590	—
Total investment securities, at fair value	\$ 319,718	\$ 340,802	\$11,825	\$174,437	\$33,701	\$24,275	\$69,705	\$ 26,859	—

(1) All covered non-agency mortgage-backed securities are covered under the loss-sharing agreement we entered into with the FDIC in connection with our 2009 acquisition. This agreement had a seven year term that expired on July 1, 2016 with respect to covered losses. On October 3, 2016, the Company entered into an agreement with the FDIC to terminate its existing loss share agreements. None of our other investment securities are covered under a loss-sharing agreement with the FDIC.

Cash and Cash Equivalents. Cash and cash equivalents increased \$15.6 million, or 7.3%, to \$228.0 million as of September 30, 2016 as compared to December 31, 2015. Cash provided by financing activities of \$337.4 million, consisting primarily of additional FHLB advances and the \$71.5 million of net proceeds from our initial public offering, combined with cash flows provided by operating activities of \$30.4 million was offset in part by cash used in investing activities of \$352.3 million. Cash used in investing activities reflected loan growth of \$325.0 million combined with the purchase of an additional \$20.0 million in bank-owned life insurance. The cash provided by operating activities reflected loans sold exceeding loans originated for sale by \$12.9 million, coupled with net income of \$20.0 million.

Goodwill and Other Intangible Assets. Goodwill was \$46.5 million at September 30, 2016, unchanged from December 31, 2015. Goodwill represents the excess of the consideration paid over the fair value of the net assets acquired. Our other intangible assets, which consist of core deposit and trust relationship intangibles, were \$5.4 million and \$7.0 million at September 30, 2016 and December 31, 2015, respectively. These assets are amortized primarily on an accelerated basis over their estimated useful lives, generally over a period of three to 10 years.

Liabilities. Total liabilities increased \$274.2 million to \$2.9 billion at September 30, 2016 due primarily to increases in deposits, short-term borrowings and FHLB advances.

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Deposits. We emphasize developing total client relationships with our customers in order to increase our retail and commercial core deposit bases, which are our primary funding sources. Our deposits consist of noninterest-bearing and interest-bearing demand, savings and time deposit accounts.

The following table summarizes our average deposit balances and weighted average rates at September 30, 2016 and December 31, 2015:

(dollars in thousands)	September 30, 2016		December 31, 2015	
	Average Balance	Weighted Average Rate	Average Balance	Weighted Average Rate
<i>Deposits:</i>				
Noninterest-bearing demand	\$ 528,238	—	\$ 536,327	—
<i>Interest-bearing:</i>				
NOW	629,052	0.13 %	508,573	0.12 %
Money market	381,682	0.27	432,570	0.22
Savings	162,890	0.15	159,345	0.13
Time, less than \$250,000	385,244	0.90	364,777	0.75
Time, \$250,000 and over	51,731	0.87	47,219	0.75
Time, brokered	216,075	1.36	198,744	1.32
Total interest-bearing	1,826,674	0.49 %	1,711,228	0.44 %
Total deposits	\$2,354,912	0.38 %	\$2,247,555	0.33 %

The following table sets forth the maturity of time deposits of \$250,000 or more and brokered deposits as of September 30, 2016:

(dollars in thousands)	September 30, 2016				
	Maturity Within:				
	Three Months or Less	Three to Six Months	Six to 12 Months	After 12 Months	Total
Time, \$250,000 and over	\$ 5,911	\$ 13,964	\$ 14,779	\$ 19,926	\$ 54,580
Brokered deposits	17,749	30,503	46,272	88,660	183,184
Total	\$ 23,660	\$ 44,467	\$ 61,051	\$ 108,586	\$ 237,764

Total deposits increased \$52.4 million, or 2.2%, to \$2.4 billion as of September 30, 2016 as compared to December 31, 2015. This increase primarily resulted from an \$85.7 million increase in noninterest-bearing deposits as new loan origination and modification payments received in conjunction with the commercial FHA business were remitted to GNMA in October 2016. This increase was offset in part by a \$33.3 million decrease in interest-bearing deposits mainly due to maturities of brokered deposits.

Short-Term Borrowings. In addition to deposits, we use short-term borrowings, such as federal funds purchased and securities sold under agreements to repurchase, as a source of funds to meet the daily liquidity needs of our customers and fund growth in earning assets. Short-term borrowings were \$138.3 million and \$107.5 million at September 30, 2016 and December 31, 2015, respectively. The weighted average interest rate on our short-term borrowings was 0.23% and 0.21% at September 30, 2016 and December 31, 2015, respectively.

FHLB Advances and Other Borrowings. In addition to deposits and short-term borrowings, we use borrowings from the FHLB and other sources as an additional source of liquidity. During the first nine months of 2016, we increased FHLB advances by \$197.4 million, which included \$100.0 million of short-term FHLB advances that matured in October 2016. The increase in FHLB advances was used by the Company to fund increased loan demand.

Subordinated Debt. In June 2015, we issued two tranches of subordinated debt instruments for aggregate proceeds of \$55.3 million. For one of the tranches, we issued subordinated notes totaling \$15.0 million with a maturity date of June 18, 2025 and a fixed interest rate of 6.50%. For the other tranche, we issued subordinated notes totaling \$40.3 million with a maturity date of June 18, 2025. This tranche carries a fixed interest rate of 6.00% for the first five years and a floating rate based on LIBOR plus 435 basis points thereafter.

On January 2, 2013, a third party committed to invest a total of \$10.0 million in the form of \$8.0 million of subordinated notes and \$2.0 million of common stock. On March 26, 2013, we issued 125,000 shares of common stock

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per the terms of the commitment. In addition, 8.25% subordinated notes totaling \$8.0 million were issued on June 28, 2013. These subordinated notes were due June 28, 2021. An 8-year detachable warrant for the purchase of 125,000 shares at \$16.00 per share of our common stock was issued concurrently with the funding of the notes. The detachable warrants became exercisable one year after issuance. The detachable warrants were valued at \$0.6 million and recorded on a relative value basis separately in shareholders' equity. Correspondingly, the value of the subordinated notes was reduced by \$0.6 million with the recording of a discount. Using proceeds from the initial public offering, the Company repaid these subordinated notes on June 28, 2016 and incurred other noninterest expense of \$0.5 million for the write-off of the remaining unamortized discount.

Capital Resources and Liquidity Management

Capital Resources. Shareholders' equity is influenced primarily by earnings, dividends, sales and redemptions of common stock and changes in accumulated other comprehensive income caused primarily by fluctuations in unrealized holding gains or losses, net of taxes, on available-for-sale investment securities.

Shareholders' equity increased \$88.7 million, or 38.1%, to \$321.8 million at September 30, 2016 as compared to December 31, 2015 due to the retention of earnings, issuances of common stock, and an increase in accumulated other comprehensive income. These increases were offset in part by dividends declared on common stock. During the first nine months of 2016, we generated net income of \$20.0 million and declared dividends of \$7.1 million to common shareholders. Shareholders' equity was also impacted by the issuance of \$71.5 million of common stock in our initial public offering. In addition, accumulated other comprehensive income increased \$3.3 million during the first nine months of 2016 due to increases in unrealized gains on covered non-agency mortgage-backed securities.

Liquidity Management. Liquidity refers to the measure of our ability to meet the cash flow requirements of depositors and borrowers, while at the same time meeting our operating, capital and strategic cash flow needs, all at a reasonable cost. We continuously monitor our liquidity position to ensure that assets and liabilities are managed in a manner that will meet all short-term and long-term cash requirements. We manage our liquidity position to meet the daily cash flow needs of customers, while maintaining an appropriate balance between assets and liabilities to meet the return on investment objectives of our shareholders.

Integral to our liquidity management is the administration of short-term borrowings. To the extent we are unable to obtain sufficient liquidity through core deposits, we seek to meet our liquidity needs through wholesale funding or other borrowings on either a short- or long-term basis.

Securities sold under agreements to repurchase, which are classified as secured borrowings, generally mature within one to four days from the transaction date. Securities sold under agreements to repurchase are reflected at the amount of cash received in connection with the transaction. The Bank may be required to provide additional collateral based on the fair value of the underlying securities. Securities sold under agreements to repurchase were \$138.3 million at September 30, 2016 compared to \$107.5 million at December 31, 2015. This increase primarily resulted from increased usage of repurchase agreements by our customers.

As of September 30, 2016 and December 31, 2015, we had \$68.0 million and \$83.0 million of unsecured federal funds lines, respectively, with no amounts advanced against the lines at either date. In addition, available lines of credit from the Federal Reserve Discount Window at September 30, 2016 and December 31, 2015 were \$39.6 million and \$62.1 million, respectively. Federal Reserve Discount Window lines were collateralized by a pool of commercial real estate loans totaling \$47.6 million and \$76.7 million as of September 30, 2016 and December 31, 2015, respectively. We did not have any borrowings outstanding with the Federal Reserve at September 30, 2016 and December 31, 2015, and our borrowing capacity is limited only by eligible collateral.

At September 30, 2016 and December 31, 2015, we had \$237.5 million and \$40.0 million of outstanding advances from the FHLB, respectively. Based on the values of stock, securities, and loans pledged as collateral, we had \$336.5 million and \$422.6 million of additional borrowing capacity with the FHLB as of September 30, 2016 and December 31, 2015, respectively. We also maintain relationships in the capital markets with brokers and dealers to issue certificates of deposit.

The Company is a corporation separate and apart from the Bank and, therefore, must provide for its own liquidity. The Company's main source of funding is dividends declared and paid to us by the Bank. There are statutory,

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regulatory and debt covenant limitations that affect the ability of the Bank to pay dividends to the Company. Management believes that these limitations will not impact our ability to meet our ongoing short-term cash obligations.

Regulatory Capital Requirements

We are subject to various regulatory capital requirements administered by the federal and state banking regulators. Failure to meet regulatory capital requirements may result in certain mandatory and possible additional discretionary actions by regulators that, if undertaken, could have a direct material effect on our financial statements. Under capital adequacy guidelines and the regulatory framework for “prompt corrective action” (described below), we must meet specific capital guidelines that involve quantitative measures of our assets, liabilities and certain off-balance sheet items as calculated under regulatory accounting policies.

The Dodd-Frank Act and the Basel III Rules have established increased capital standards for banks and bank holding companies and require more capital to be held in the form of common stock. The table below summarizes the minimum capital requirements applicable to us under the Basel III Rules.

Ratio	Basel III	
	Well Capitalized	Adequately Capitalized
Tier 1 leverage ratio	5.0 %	4.0 %
Common equity Tier 1 risk-based capital ratio ⁽¹⁾	6.5	4.5
Tier 1 risk-based capital ratio	8.0	6.0
Total risk-based capital ratio	10.0	8.0

(1) The common equity Tier 1 risk-based ratio is a new ratio created by the Basel III Rules beginning January 1, 2015. It is computed as common equity Tier 1 capital divided by total risk-based assets.

In addition to the minimum regulatory capital requirements set forth in the table above, the Basel III Rules have implemented a “capital conservation buffer” that is added to the minimum requirements for capital adequacy purposes. A banking organization that fails to meet the required amount of the capital conservation buffer will be subject to limits on capital distributions (e.g., dividends, stock buybacks, etc.) and certain discretionary bonus payments to executive officers. For community banks, the capital conservation buffer requirement is being phased in over a three-year period beginning on January 1, 2016. The capital conservation buffer in 2016 is 0.625% and will increase by 0.625% on January 1 of each year until fully phased in at 2.5% on January 1, 2019.

At September 30, 2016, the Bank exceeded all regulatory capital requirements under the Basel III Rules and was considered to be “well-capitalized” with a Tier 1 leverage ratio of 10.00%, a common equity Tier 1 capital ratio of 11.14%, a Tier 1 capital ratio of 11.14% and a total capital ratio of 11.72%.

Contractual Obligations

The following table contains supplemental information regarding our total contractual obligations at September 30, 2016:

(dollars in thousands)	Payments Due				Total
	Within One Year	One to Three Years	Three to Five Years	After Five Years	
Deposits without a stated maturity	\$ 1,816,069	\$ —	\$ —	\$ —	\$ 1,816,069
Time deposits	335,018	255,742	12,992	211	603,963
Securities sold under repurchase agreements	138,289	—	—	—	138,289
FHLB advances and other borrowings	127,537	6	35,000	75,000	237,543
Operating lease obligations	2,331	3,970	3,410	5,480	15,191
Subordinated debt	—	—	—	54,484	54,484
Trust preferred debentures	—	—	—	37,316	37,316
Total contractual obligations	\$ 2,419,244	\$ 259,718	\$ 51,402	\$ 172,491	\$ 2,902,855

We believe that we will be able to meet our contractual obligations as they come due through the maintenance of adequate cash levels. We expect to maintain adequate cash levels through profitability, loan and securities repayment and maturity activity and continued deposit gathering activities. We have in place various borrowing mechanisms for both short-term and long-term liquidity needs.

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Quantitative and Qualitative Disclosures About Market Risk

Market Risk. Market risk represents the risk of loss due to changes in market values of assets and liabilities. We incur market risk in the normal course of business through exposures to market interest rates, equity prices, and credit spreads. We have identified two primary sources of market risk: interest rate risk and price risk.

Interest Rate Risk

Overview. Interest rate risk is the risk to earnings and value arising from changes in market interest rates. Interest rate risk arises from timing differences in the repricings and maturities of interest-earning assets and interest-bearing liabilities (reprice risk), changes in the expected maturities of assets and liabilities arising from embedded options, such as borrowers' ability to prepay residential mortgage loans at any time and depositors' ability to redeem certificates of deposit before maturity (option risk), changes in the shape of the yield curve where interest rates increase or decrease in a nonparallel fashion (yield curve risk), and changes in spread relationships between different yield curves, such as U.S. Treasuries and LIBOR (basis risk).

Our board of directors Asset-Liability Committee ("ALCO") establishes broad policy limits with respect to interest rate risk. ALCO establishes specific operating guidelines within the parameters of the board of directors' policies. In general, we seek to minimize the impact of changing interest rates on net interest income and the economic values of assets and liabilities. Our ALCO meets quarterly to monitor the level of interest rate risk sensitivity to ensure compliance with the board of directors' approved risk limits.

Interest rate risk management is an active process that encompasses monitoring loan and deposit flows complemented by investment and funding activities. Effective management of interest rate risk begins with understanding the dynamic characteristics of assets and liabilities and determining the appropriate interest rate risk posture given business forecasts, management objectives, market expectations, and policy constraints.

An asset sensitive position refers to a balance sheet position in which an increase in short-term interest rates is expected to generate higher net interest income, as rates earned on our interest-earning assets would reprice upward more quickly than rates paid on our interest-bearing liabilities, thus expanding our net interest margin. Conversely, a liability sensitive position refers to a balance sheet position in which an increase in short-term interest rates is expected to generate lower net interest income, as rates paid on our interest-bearing liabilities would reprice upward more quickly than rates earned on our interest-earning assets, thus compressing our net interest margin.

Income Simulation and Economic Value Analysis. Interest rate risk measurement is calculated and reported to the ALCO at least quarterly. The information reported includes period-end results and identifies any policy limits exceeded, along with an assessment of the policy limit breach and the action plan and timeline for resolution, mitigation, or assumption of the risk.

We use two approaches to model interest rate risk: Net Interest Income at Risk ("NII at Risk") and Economic Value of Equity ("EVE"). Under NII at Risk, net interest income is modeled utilizing various assumptions for assets, liabilities, and derivatives. EVE measures the period end market value of assets minus the market value of liabilities and the change in this value as rates change. EVE is a period end measurement.

The following table shows NII at Risk at the dates indicated:

(dollars in thousands)	Net Interest Income Sensitivity		
	Immediate Change in Rates		
	-50	+100	+200
September 30, 2016:			
Dollar change	\$ (2,949)	\$ 4,289	\$ 8,223
Percent change	(2.9)%	4.2 %	8.1 %
December 31, 2015:			
Dollar change	\$ (759)	\$ 1,356	\$ 2,999
Percent change	(0.9)%	1.5 %	3.4 %

We report NII at Risk to isolate the change in income related solely to interest earning assets and interest-bearing liabilities. The NII at Risk results included in the table above reflect the analysis used quarterly by management. It models gradual -50, +100 and +200 basis point parallel shifts in market interest rates, implied by the forward yield curve over the next one-year period. Due to the current low level of short-term interest rates, the analysis reflects a declining interest rate scenario of 50 basis points, the point at which many assets and liabilities reach zero percent.

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We are within Board policy limits for the +100 and +200 basis point scenarios. There is no policy limit for the –50 basis point scenario. The NII at Risk reported at September 30, 2016, projects that our earnings exhibit increased sensitivity to changes in interest rates compared to December 31, 2015. In recent periods, the amount of fixed rate assets increased, resulting in a position shift from slightly asset sensitive to asset sensitive.

The following table shows EVE at the dates indicated:

(dollars in thousands)	Economic Value of Equity Sensitivity		
	Immediate Change in Rates		
	–50	+100	+200
September 30, 2016:			
Dollar change	\$ (22,201)	\$ 35,525	\$ 65,518
Percent change	(7.2)%	11.5 %	21.3 %
December 31, 2015:			
Dollar change	\$ (16,147)	\$ 29,080	\$ 55,533
Percent change	(6.3)%	11.3 %	21.6 %

The EVE results included in the table above reflect the analysis used quarterly by management. It models immediate –50, +100 and +200 basis point parallel shifts in market interest rates. Due to the current low level of short-term interest rates, the analysis reflects a declining interest rate scenario of 50 basis points, the point at which many assets and liabilities reach zero percent.

We are within board policy limits for the +100 and +200 basis point scenarios. There is no policy limit for the –50 basis point scenario. The EVE reported at September 30, 2016 projects that as interest rates increase, the economic value of equity position will increase, and as interest rates decrease, the economic value of equity position will decrease. When interest rates rise, fixed rate assets generally lose economic value; the longer the duration, the greater the value lost. The opposite is true when interest rates fall.

Price Risk. Price risk represents the risk of loss arising from adverse movements in the prices of financial instruments that are carried at fair value and subject to fair value accounting. We have price risk from equity investments and investments in mortgage-backed securities.

Non-GAAP Financial Measures

Our management uses the following non-GAAP financial measure in its analysis of our performance: “yield on loans excluding accretion income” and “net interest margin excluding accretion income.”

Yield on Loans Excluding Accretion Income and Net Interest Margin Excluding Accretion Income. Management uses the measures yield on loans excluding accretion income and net interest margin excluding accretion income to assess the impact of purchase accounting on the yield on loans and net interest margin. These metrics better assess the impact of purchase accounting on yield on loans and net interest margin, as the effect of loan discount accretion is expected to decrease as the acquired loans mature or roll off of our balance sheet. We believe that these non-GAAP financial measures provide meaningful additional information about us to assist investors in evaluating our operating results. These non-GAAP financial measures should not be considered substitutes for results determined in accordance with GAAP and may not be comparable to other similarly titled measures used by other companies. The following table reconciles yield on loans excluding accretion income and net interest margin excluding accretion income to their most comparable GAAP measure.

	For the Three Months Ended		For the Nine Months Ended	
	September 30,		September 30,	
	2016	2015	2016	2015
Yield on Loans:				
Reported yield on loans	4.79 %	4.94 %	4.90 %	5.22 %
Effect of accretion income on acquired loans	(0.41)%	(0.41)%	(0.53)%	(0.72)%
Yield on loans excluding accretion income	<u>4.38 %</u>	<u>4.53 %</u>	<u>4.37 %</u>	<u>4.50 %</u>
Net Interest Margin:				
Reported net interest margin	4.00 %	4.17 %	4.01 %	4.45 %
Effect of accretion income on acquired loans	(0.34)%	(0.34)%	(0.43)%	(0.58)%
Net interest margin excluding accretion income	<u>3.66 %</u>	<u>3.83 %</u>	<u>3.58 %</u>	<u>3.87 %</u>

Item 3 – Quantitative and Qualitative Disclosures About Market Risk

The quantitative and qualitative disclosures about market risk are included under “Item 2 – Management’s Discussion and Analysis of Financial Condition and Results of Operations – Quantitative and Qualitative Disclosures About Market Risk,” appearing on pages 66 through 67 of this report.

Item 4 – Controls and Procedures

Evaluation of disclosure controls and procedures. The Company’s management, including our President and Chief Executive Officer and our Chief Financial Officer, have evaluated the effectiveness of our “disclosure controls and procedures” (as defined in Rules 13a-15(e) under the Securities Exchange Act of 1934, or the “Exchange Act”), as of the end of the period covered by this report. Based on such evaluation, our President and Chief Executive Officer and our Chief Financial Officer have concluded that, as of the end of such period, the Company’s disclosure controls and procedures were effective as of that date to provide reasonable assurance that the information required to be disclosed by the Company in the reports it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the SEC and that information required to be disclosed by the Company in the reports it files or submits under the Exchange Act is accumulated and communicated to the Company’s management, including its President and Chief Executive Officer and its Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

Changes in Internal Control over Financial Reporting. There have not been any changes in the Company’s internal control over financial reporting (as such term is defined in Rules 13a-15(f) under the Exchange Act) during the fiscal quarter to which this report relates that have materially affected, or are reasonably likely to materially affect, the Company’s internal control over financial reporting.

Part II – Other Information

Item 1 – Legal Proceedings

In the normal course of business, we are named or threatened to be named as a defendant in various lawsuits, none of which we expect to have a material effect on the Company. However, given the nature, scope and complexity of the extensive legal and regulatory landscape applicable to our business (including laws and regulations governing consumer protection, fair lending, fair labor, privacy, information security and anti-money laundering and anti-terrorism laws), we, like all banking organizations, are subject to heightened legal and regulatory compliance and litigation risk. There are no material pending legal proceedings, other than ordinary routine litigation incidental to the business, to which the Company or any of its subsidiaries is a party or of which any of their property is the subject.

Item 1A – Risk Factors

There have been no material changes from the risk factors previously disclosed in the “Risk Factors” section included in our prospectus filed with the SEC on May 24, 2016 pursuant to Rule 424(b)(4) under the Securities Act.

Item 2 – Unregistered Sales of Equity Securities and Use of Proceeds

Unregistered Sales of Equity Securities

None.

Use of Proceeds from Registered Securities

On May 24, 2016, the Company sold 3,044,252 shares of common stock in its initial public offering, and on June 6, 2016, the Company issued an additional 545,813 shares of common stock when the underwriters for the initial public offering fully exercised their option to purchase additional shares. All of the shares were sold pursuant to our Registration Statement on Form S-1, as amended (File No. 333-210683), which was declared effective by the SEC on May 23, 2016. Our common stock is currently traded on the NASDAQ under the symbol “MSBI”.

There has been no material change in the planned use of proceeds from our initial public offering as described in our prospectus filed with the SEC on May 24, 2016 pursuant to Rule 424(b)(4) under the Securities Act. From the effective date of the registration statement through September 30, 2016, the Company contributed \$25.0 million of the net proceeds of the initial public offering to the Bank, and used \$8.0 million to redeem the Company’s outstanding 8.25% subordinated notes due June 2021.

Item 6 – Exhibits

Exhibit No.	Description
31.1	Chief Executive Officer’s Certification required by Rule 13(a)-14(a) – filed herewith.
31.2	Chief Financial Officer’s Certification required by Rule 13(a)-14(a) – filed herewith.
32.1	Chief Executive Officer Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 – filed herewith.
32.2	Chief Financial Officer Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 – filed herewith.
101	Financial information from the Company’s Quarterly Report on Form 10-Q for the quarterly period ended September 30, 2016, formatted in XBRL interactive data files pursuant to Rule 405 of Regulation S-T: (i) Consolidated Balance Sheets; (ii) Consolidated Statements of Income; (iii) Consolidated Statements of Comprehensive Income; (iv) Consolidated Statements of Shareholders’ Equity; (v) Consolidated Statements of Cash Flows; and (vi) Notes to Consolidated Financial Statements – filed herewith.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

MIDLAND STATES BANCORP, INC.

Date: November 9, 2016

By: /s/ Leon J. Holschbach
Leon J. Holschbach
President and Chief Executive Officer
(Principal Executive Officer)

Date: November 9, 2016

By: /s/ Jeffrey G. Ludwig
Jeffrey G. Ludwig
Executive Vice President and Chief Financial Officer
(Principal Financial and Accounting Officer)

**CERTIFICATIONS REQUIRED BY
RULE 13a-14(a) OR RULE 15d-14(a)
UNDER THE SECURITIES EXCHANGE ACT OF 1934**

I, Leon J. Holschbach , certify that:

1. I have reviewed this Quarterly Report on Form 10-Q (the "Report") of Midland States Bancorp, Inc. (the "Registrant");
2. Based on my knowledge, this Report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this Report;
3. Based on my knowledge, the financial statements, and other financial information included in this Report, fairly present in all material respects the financial condition, results of operations and cash flows of the Registrant as of, and for, the periods presented in this Report;
4. The Registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the Registrant and have:
 - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the Registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this Report is being prepared;
 - b) [Reserved]
 - c) Evaluated the effectiveness of the Registrant's disclosure controls and procedures and presented in this Report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this Report based on such evaluation; and
 - d) Disclosed in this Report any change in the Registrant's internal control over financial reporting that occurred during the Registrant's most recent fiscal quarter (the Registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the Registrant's internal control over financial reporting; and
5. The Registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the Registrant's auditors and the audit committee of the Registrant's board of directors (or persons performing the equivalent functions):
 - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the Registrant's ability to record, process, summarize and report financial information; and
 - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the Registrant's internal control over financial reporting.

MIDLAND STATES BANCORP, INC.

Dated as of: November 9, 2016

By: /s/ Leon J. Holschbach
Leon J. Holschbach
President and Chief Executive Officer
(Principal Executive Officer)

**CERTIFICATIONS REQUIRED BY
RULE 13a-14(a) OR RULE 15d-14(a)
UNDER THE SECURITIES EXCHANGE ACT OF 1934**

I, Jeffrey G. Ludwig, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q (the "Report") of Midland States Bancorp, Inc. (the "Registrant");
2. Based on my knowledge, this Report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this Report;
3. Based on my knowledge, the financial statements, and other financial information included in this Report, fairly present in all material respects the financial condition, results of operations and cash flows of the Registrant as of, and for, the periods presented in this Report;
4. The Registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the Registrant and have:
 - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the Registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this Report is being prepared;
 - b) [Reserved]
 - c) Evaluated the effectiveness of the Registrant's disclosure controls and procedures and presented in this Report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this Report based on such evaluation; and
 - d) Disclosed in this Report any change in the Registrant's internal control over financial reporting that occurred during the Registrant's most recent fiscal quarter (the Registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the Registrant's internal control over financial reporting; and
5. The Registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the Registrant's auditors and the audit committee of the Registrant's board of directors (or persons performing the equivalent functions):
 - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the Registrant's ability to record, process, summarize and report financial information; and
 - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the Registrant's internal control over financial reporting.

MIDLAND STATES BANCORP, INC.

Dated as of: November 9, 2016

By: /s/ Jeffrey G. Ludwig
Jeffrey G. Ludwig
Executive Vice President and Chief Financial Officer
(Principal Financial and Accounting Officer)

**CERTIFICATIONS PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

I, Leon J. Holschbach, President and Chief Executive Officer of Midland States Bancorp, Inc. (the "Company") certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that to the best of my knowledge:

- (1) The Quarterly Report on Form 10-Q of the Company for the quarterly period ended September 30, 2016 (the "Report") fully complies with the requirements of Sections 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

MIDLAND STATES BANCORP, INC.

Dated as of: November 9, 2016

By: /s/ Leon J. Holschbach
Leon J. Holschbach
President and Chief Executive Officer
(Principal Executive Officer)

**CERTIFICATIONS PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

I, Jeffrey G. Ludwig, Executive Vice President and Chief Financial Officer of Midland States Bancorp, Inc. (the "Company") certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that to the best of my knowledge:

- (1) The Quarterly Report on Form 10-Q of the Company for the quarterly period ended September 30, 2016 (the "Report") fully complies with the requirements of Sections 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

MIDLAND STATES BANCORP, INC.

Dated as of: November 9, 2016

By: /s/ Jeffrey G. Ludwig
Jeffrey G. Ludwig
Executive Vice President and Chief Financial Officer
(Principal Financial and Accounting Officer)
