

OLD SECOND BANCORP INC  
Form 10-Q  
May 13, 2014  
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**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF  
THE SECURITIES EXCHANGE ACT OF 1934**  
For the quarterly period ended March 31, 2014

o **OR**  
**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE  
SECURITIES EXCHANGE ACT OF 1934**  
For transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number 0 -10537

**OLD SECOND BANCORP, INC.**

(Exact name of Registrant as specified in its charter)

**Delaware**

(State or other jurisdiction  
of incorporation or organization)

**36-3143493**

(I.R.S. Employer Identification Number)

**37 South River Street, Aurora, Illinois 60507**

(Address of principal executive offices) (Zip Code)

**(630) 892-0202**

(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

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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 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 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 Act. (Check one):

Large accelerated filer  Accelerated filer  Non-accelerated filer  (do not check if a smaller reporting company) 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

Indicate the number of shares outstanding of each of the issuer's classes of common stock as of the latest practicable date: As of May 9, 2014, the Registrant had outstanding 29,442,508 shares of common stock, \$1.00 par value per share.

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**OLD SECOND BANCORP, INC.**

Form 10-Q Quarterly Report

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PART I

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Table of Contents**PART I - FINANCIAL INFORMATION****Item 1. Financial Statements****Old Second Bancorp, Inc. and Subsidiaries****Consolidated Balance Sheets***(In thousands, except share data)*

|   | (Unaudited)<br>March 31,<br>2014 | December 31,<br>2013 |
|---|----------------------------------|----------------------|
| <b>Assets</b>   |                                  |                      |
| Cash and due from banks                               | \$ 40,245                        | \$ 33,210            |
| Interest bearing deposits with financial institutions | 14,242                           | 14,450               |
| Cash and cash equivalents                             | 54,487                           | 47,660               |
| Securities available-for-sale, at fair value          | 400,212                          | 372,191              |
| Securities held-to-maturity, at amortized cost        | 264,298                          | 256,571              |
| Federal Home Loan Bank and Federal Reserve Bank stock | 10,292                           | 10,292               |
| Loans held-for-sale                                   | 2,507                            | 3,822                |
| Loans   | 1,111,237                        | 1,101,256            |
| Less: allowance for loan losses                       | 25,476                           | 27,281               |
| Net loans   | 1,085,761                        | 1,073,975            |
| Premises and equipment, net                           | 45,716                           | 46,005               |
| Other real estate owned                               | 40,220                           | 41,537               |
| Mortgage servicing rights, net                        | 5,614                            | 5,807                |
| Core deposit intangible, net                          | 665                              | 1,177                |
| Bank-owned life insurance (BOLI)                      | 55,768                           | 55,410               |
| Deferred tax assets, net                              | 74,453                           | 75,303               |
| Other assets  | 19,426                           | 14,284               |
| Total assets  | \$ 2,059,419                     | \$ 2,004,034         |
| <b>Liabilities</b>                                    |                                  |                      |
| Deposits:   |                                  |                      |
| Noninterest bearing demand                            | \$ 387,090                       | \$ 373,389           |
| Interest bearing:                                     |                                  |                      |
| Savings, NOW, and money market                        | 872,521                          | 836,300              |
| Time  | 464,670                          | 472,439              |
| Total deposits  | 1,724,281                        | 1,682,128            |
| Securities sold under repurchase agreements           | 23,212                           | 22,560               |
| Other short-term borrowings                           | 20,000                           | 5,000                |
| Junior subordinated debentures                        | 58,378                           | 58,378               |
| Subordinated debt                                     | 45,000                           | 45,000               |
| Notes payable and other borrowings                    | 500                              | 500                  |
| Other liabilities                                     | 38,560                           | 42,776               |
| Total liabilities                                     | 1,909,931                        | 1,856,342            |
| <b>Stockholders Equity</b>                            |                                  |                      |
| Preferred stock                                       | 73,000                           | 72,942               |
| Common stock  | 18,840                           | 18,830               |
| Additional paid-in capital                            | 66,297                           | 66,212               |
| Retained earnings                                     | 94,693                           | 92,549               |

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|  |    |           |    |           |
|--|----|-----------|----|-----------|
| Accumulated other comprehensive loss       |    | (7,493)   |    | (7,038)   |
| Treasury stock                             |    | (95,849)  |    | (95,803)  |
| Total stockholders' equity                 |    | 149,488   |    | 147,692   |
| Total liabilities and stockholders' equity | \$ | 2,059,419 | \$ | 2,004,034 |

|                    | March 31, 2014  |              | December 31, 2013 |              |
|--------------------|-----------------|--------------|-------------------|--------------|
|                    | Preferred Stock | Common Stock | Preferred Stock   | Common Stock |
| Par value          | \$ 1            | \$ 1         | \$ 1              | \$ 1         |
| Liquidation value  | 1,000           | n/a          | 1,000             | n/a          |
| Shares authorized  | 300,000         | 60,000,000   | 300,000           | 60,000,000   |
| Shares issued      | 73,000          | 18,839,734   | 73,000            | 18,829,734   |
| Shares outstanding | 73,000          | 13,917,508   | 73,000            | 13,917,108   |
| Treasury shares    | -               | 4,922,226    | -                 | 4,912,626    |

See accompanying notes to consolidated financial statements.

Table of Contents**Old Second Bancorp, Inc. and Subsidiaries****Consolidated Statements of Operations***(In thousands, except share data)*

|  | (Unaudited)               |             |
|--|---------------------------|-------------|
|  | <b>Three Months Ended</b> |             |
|  | <b>March 31,</b>          |             |
|  | <b>2014</b>               | <b>2013</b> |
| <b>Interest and dividend income</b>                                  |                           |             |
| Loans, including fees  | \$ 12,938                 | \$ 14,914   |
| Loans held-for-sale  | 25                        | 41          |
| Securities:  |                           |             |
| Taxable  | 3,502                     | 2,298       |
| Tax-exempt   | 148                       | 119         |
| Dividends from Federal Reserve Bank and Federal Home Loan Bank stock | 76                        | 76          |
| Interest bearing deposits with financial institutions                | 15                        | 42          |
| Total interest and dividend income                                   | 16,704                    | 17,490      |
| <b>Interest expense</b>  |                           |             |
| Savings, NOW, and money market deposits                              | 199                       | 228         |
| Time deposits  | 1,321                     | 1,853       |
| Securities sold under repurchase agreements                          | 1                         | 1           |
| Other short-term borrowings  | 1                         | 19          |
| Junior subordinated debentures                                       | 1,387                     | 1,287       |
| Subordinated debt  | 196                       | 196         |
| Notes payable and other borrowings                                   | 4                         | 4           |
| Total interest expense   | 3,109                     | 3,588       |
| Net interest and dividend income                                     | 13,595                    | 13,902      |
| Loan loss reserve release  | (1,000)                   | (2,500)     |
| Net interest and dividend income after loan loss reserve release     | 14,595                    | 16,402      |
| <b>Noninterest income</b>  |                           |             |
| Trust income   | 1,459                     | 1,491       |
| Service charges on deposits  | 1,720                     | 1,677       |
| Secondary mortgage fees  | 112                       | 230         |
| Mortgage servicing (loss) gain, net of changes in fair value         | (47)                      | 244         |
| Net gain on sales of mortgage loans                                  | 662                       | 1,976       |
| Securities (losses) gains, net                                       | (69)                      | 1,453       |
| Increase in cash surrender value of bank-owned life insurance        | 358                       | 407         |
| Debit card interchange income  | 830                       | 792         |
| Other income   | 1,296                     | 1,737       |
| Total noninterest income   | 6,321                     | 10,007      |
| <b>Noninterest expense</b>   |                           |             |
| Salaries and employee benefits                                       | 9,101                     | 9,032       |
| Occupancy expense, net   | 1,481                     | 1,279       |
| Furniture and equipment expense                                      | 983                       | 1,144       |
| FDIC insurance   | 279                       | 1,035       |
| General bank insurance   | 489                       | 849         |
| Amortization of core deposit   | 512                       | 525         |
| Advertising expense  | 303                       | 166         |
| Debit card interchange expense                                       | 378                       | 344         |
| Legal fees   | 257                       | 323         |
| Other real estate expense, net                                       | 1,008                     | 3,097       |
| Other expense  | 2,725                     | 3,144       |
| Total noninterest expense  | 17,516                    | 20,938      |
| Income before income taxes   | 3,400                     | 5,471       |

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|  |    |       |    |       |
|--|----|-------|----|-------|
| Income tax expense   |    | 1,198 |    | -     |
| <b>Net income</b>  |    | 2,202 |    | 5,471 |
| <b>Preferred stock dividends and accretion of discount</b> |    | 1,572 |    | 1,289 |
| <b>Net income available to common shareholders</b>         | \$ | 630   | \$ | 4,182 |
| <b>Share and per share information:</b>                    |    |       |    |       |
| Basic income per share                                     | \$ | 0.04  | \$ | 0.30  |
| Diluted income per share                                   |    | 0.04  |    | 0.30  |
| Dividends paid per share                                   |    | -     |    | -     |

See accompanying notes to consolidated financial statements.

Table of Contents**Old Second Bancorp, Inc. and Subsidiaries****Consolidated Statements of Comprehensive Income**

(In thousands)

|  | (Unaudited)               |             |
|--|---------------------------|-------------|
|  | <b>Three Months Ended</b> |             |
|  | <b>March 31,</b>          |             |
|  | <b>2014</b>               | <b>2013</b> |
| Net income   | \$ 2,202                  | \$ 5,471    |
| Total unrealized holding losses on available-for-sale securities arising during the period                   | (1,089)                   | (35)        |
| Related tax benefit  | 448                       | 17          |
| Holding losses after tax   | (641)                     | (18)        |
| Less: Reclassification adjustment for the net gains and losses realized during the period                    |                           |             |
| Net realized (losses) gains  | (69)                      | 1,453       |
| Income tax benefit (expense) on net realized gains   | 28                        | (596)       |
| Net realized (losses) gains after tax  | (41)                      | 857         |
| Other comprehensive loss on available-for-sale securities  | (600)                     | (875)       |
| Accretion of net unrealized holding gains on held-to-maturity transferred from available-for-sale securities | 247                       | -           |
| Related tax expense  | (102)                     | -           |
| Other comprehensive income on held-to-maturity securities  | 145                       | -           |
| Total other comprehensive loss   | (455)                     | (875)       |
| Total comprehensive income   | \$ 1,747                  | \$ 4,596    |

See accompanying notes to consolidated financial statements.



Table of Contents**Old Second Bancorp, Inc. and Subsidiaries****Consolidated Statements of Cash Flows**

(In thousands)

|   | (Unaudited)               |             |
|---|---------------------------|-------------|
|   | <b>Three Months Ended</b> |             |
|   | <b>March 31,</b>          |             |
|   | <b>2014</b>               | <b>2013</b> |
| <b>Cash flows from operating activities</b>   |                           |             |
| Net income  | \$ 2,202                  | \$ 5,471    |
| Adjustments to reconcile net income to net cash (used in) provided by operating activities: |                           |             |
| Depreciation and amortization of leasehold improvement                                      | 644                       | 746         |
| Change in market value on mortgage servicing rights   | 304                       | 106         |
| Loan loss reserve release   | (1,000)                   | (2,500)     |
| Gain on recapture of restricted stock   | -                         | (612)       |
| Provision for deferred tax expense  | 1,168                     | -           |
| Originations of loans held-for-sale   | (19,764)                  | (53,138)    |
| Proceeds from sales of loans held-for-sale  | 21,592                    | 57,755      |
| Net gain on sales of mortgage loans   | (662)                     | (1,976)     |
| Increase in cash surrender value of bank-owned life insurance                               | (358)                     | (407)       |
| Change in accrued interest receivable and other assets                                      | (6,238)                   | (5,215)     |
| Change in accrued interest payable and other liabilities                                    | (3,082)                   | 634         |
| Net discount (accretion)/premium amortization on securities                                 | (474)                     | 414         |
| Securities losses (gains), net  | 69                        | (1,453)     |
| Amortization of core deposit, net   | 512                       | 525         |
| Tax effect on vesting of restricted stock   | 29                        | -           |
| Stock based compensation  | 66                        | 14          |
| Net gain on sale of other real estate owned   | (386)                     | (181)       |
| Provision for other real estate owned losses  | 436                       | 1,987       |
| Net gain on disposal of fixed assets  | -                         | (5)         |
| Net cash (used in) provided by operating activities   | (4,942)                   | 2,165       |
| <b>Cash flows from investing activities</b>   |                           |             |
| Proceeds from maturities and calls including pay down of securities available-for-sale      | 2,361                     | 18,055      |
| Proceeds from sales of securities available-for-sale  | 31,781                    | 231,155     |
| Purchases of securities available-for-sale  | (62,931)                  | (240,190)   |
| Proceeds from maturities and calls including pay down of securities held-to-maturity        | 1,893                     | -           |
| Purchases of securities held-to-maturity  | (9,220)                   | -           |
| Net change in loans   | (15,474)                  | 26,971      |
| Improvements in other real estate owned   | -                         | (50)        |
| Proceeds from sales of other real estate owned  | 5,955                     | 11,842      |
| Proceeds from disposition of fixed assets   | -                         | 6           |
| Net purchases of premises and equipment   | (355)                     | (1,123)     |
| Net cash (used in) provided by investing activities   | (45,990)                  | 46,666      |
| <b>Cash flows from financing activities</b>   |                           |             |
| Net change in deposits  | 42,153                    | 1,037       |
| Net change in securities sold under repurchase agreements                                   | 652                       | 2,927       |
| Net change in other short-term borrowings   | 15,000                    | (100,000)   |
| Purchase of treasury stock  | (46)                      | (185)       |
| Net cash provided by (used in) financing activities   | 57,759                    | (96,221)    |
| Net change in cash and cash equivalents   | 6,827                     | (47,390)    |
| Cash and cash equivalents at beginning of period  | 47,660                    | 128,507     |
| Cash and cash equivalents at end of period  | \$ 54,487                 | \$ 81,117   |



Table of Contents**Old Second Bancorp, Inc. and Subsidiaries****Consolidated Statements of Cash Flows - Continued**

(In thousands)

|  | (Unaudited)<br>Three Months Ended<br>March 31, |             |
|--|--|-------------|
| <b>Supplemental cash flow information</b>                  | <b>2014</b>                                    | <b>2013</b> |
| Interest paid for deposits                                 | \$ 1,584                                       | \$ 2,124    |
| Interest paid for borrowings                               | 202  | 225         |
| Noncash transfer of loans to other real estate owned       | 4,688  | 6,985       |
| Noncash transfer of loans to securities available-for-sale | -  | 5,329       |
| Accretion on preferred stock warrants                      | 58   | 261         |
| Fair value difference on recapture of restricted stock     | -  | 43          |

See accompanying notes to consolidated financial statements.

**Old Second Bancorp, Inc. and Subsidiaries****Consolidated Statements of Changes in****Stockholders Equity**

(In thousands)

(Unaudited)

|   | Common<br>Stock | Preferred<br>Stock | Additional<br>Paid-In<br>Capital | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Loss | Treasury<br>Stock | Total<br>Stockholders<br>Equity |
|---|-----------------|--------------------|----------------------------------|----------------------|---|-------------------|---------------------------------|
| Balance, December 31, 2012  | \$ 18,729       | \$ 71,869          | \$ 66,189                        | \$ 12,048            | \$ (1,327)                                    | \$ (94,956)       | \$ 72,552                       |
| Net income  |                 |                    |                                  | 5,471                |   |                   | 5,471                           |
| Change in net unrealized loss on securities available-for-sale, net of \$613 tax effect |                 |                    |                                  |                      | (875)   |                   | (875)                           |
| Change in restricted stock  | 51              |                    | (51)                             |                      |   |                   | -                               |
| Recapture of restricted stock   |                 |                    | (43)                             |                      |   | (569)             | (612)                           |
| Stock based compensation  |                 |                    | 14                               |                      |   |                   | 14                              |
| Purchase of treasury stock  |                 |                    |                                  |                      |   | (185)             | (185)                           |
|   |                 | 261                |                                  | (772)                |   |                   | (511)                           |

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|  |    |        |    |        |    |        |    |        |    |         |      |          |    |         |
|--|----|--------|----|--------|----|--------|----|--------|----|---------|------|----------|----|---------|
| Preferred stock accretion and declared dividends                     |    |        |    |        |    |        |    |        |    |         |      |          |    |         |
| Balance, March 31, 2013  | \$ | 18,780 | \$ | 72,130 | \$ | 66,109 | \$ | 16,747 | \$ | (2,202) | \$   | (95,710) | \$ | 75,854  |
| Balance, December 31, 2013   | \$ | 18,830 | \$ | 72,942 | \$ | 66,212 | \$ | 92,549 | \$ | (7,038) | \$   | (95,803) | \$ | 147,692 |
| Net income   |    |        |    |        |    |        |    | 2,202  |    |         |      |          |    | 2,202   |
| Change in net unrealized loss on securities, net of \$318 tax effect |    |        |    |        |    |        |    |        |    | (455)   |      |          |    | (455)   |
| Change in restricted stock   |    | 10     |    |        |    | (10)   |    |        |    |         |      |          |    | -       |
| Tax effect from vesting of restricted stock                          |    |        |    |        |    | 29     |    |        |    |         |      |          |    | 29      |
| Stock based compensation   |    |        |    |        |    | 66     |    |        |    |         |      |          |    | 66      |
| Purchase of treasury stock   |    |        |    |        |    |        |    |        |    |         | (46) |          |    | (46)    |
| Preferred stock accretion and declared dividends                     |    |        |    | 58     |    |        |    | (58)   |    |         |      |          |    | -       |
| Balance, March 31, 2014  | \$ | 18,840 | \$ | 73,000 | \$ | 66,297 | \$ | 94,693 | \$ | (7,493) | \$   | (95,849) | \$ | 149,488 |

See accompanying notes to consolidated financial statements.

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**Old Second Bancorp, Inc. and Subsidiaries**

**Notes to Consolidated Financial Statements**

(Table amounts in thousands, except per share data, unaudited)

**Note 1 Summary of Significant Accounting Policies**

The accounting policies followed in the preparation of the interim financial statements are consistent with those used in the preparation of the annual financial information. The interim financial statements reflect all normal and recurring adjustments, which are necessary, in the opinion of management, for a fair statement of results for the interim period presented. Results for the period ended March 31, 2014, are not necessarily indicative of the results that may be expected for the year ending December 31, 2014. These interim financial statements should be read in conjunction with the audited financial statements and notes included in Old Second Bancorp, Inc.'s (the Company) annual report on Form 10-K for the year ended December 31, 2013. Unless otherwise indicated, amounts in the tables contained in the notes are in thousands. Certain items in prior periods have been reclassified to conform to the current presentation.

The Company's consolidated financial statements are prepared in accordance with generally accepted accounting principles in the United States (GAAP) and follow general practices within the banking industry. Application of these principles requires management to make estimates, assumptions, and judgments that affect the amounts reported in the financial statements and accompanying notes. These estimates, assumptions, and judgments are based on information available as of the date of the financial statements. Future changes in information may affect these estimates, assumptions, and judgments, which, in turn, may affect amounts reported in the financial statements.

All significant accounting policies are presented in Note 1 to the consolidated financial statements included in the Company's annual report on Form 10-K for the year ended December 31, 2013. These policies, along with the disclosures presented in the other financial statement notes and in this discussion, provide information on how significant assets and liabilities are valued in the financial statements and how those values are determined.

**Recent Accounting Pronouncements**

In July 2013, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2013-11 *Income Taxes (Topic 740) Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists*. ASU 2013-11 amended existing guidance related to the presentation of an unrecognized tax benefit when a net operating loss carryforward, a similar tax loss or a tax credit carryforward exists. These amendments provide that an unrecognized tax benefit, or a portion thereof, be presented in the financial statements as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward, except to the extent that a net operating loss carryforward, a similar tax loss, or a tax credit carryforward is not available at the reporting date to settle any additional income taxes that would result from disallowance of a tax position, or the tax law does not require the entity to use, and the entity does not intend to use, the deferred tax asset for such purpose, then the unrecognized tax benefit should be presented as a liability. These amendments are effective for interim and annual reporting periods beginning after December 15, 2013, and are incorporated in the financial statements contained in this report. The effect of adopting this standard does not have a material effect on the Company's operating results or financial condition.

In January 2014, the FASB issued ASU No. 2014-04 *Receivables - Troubled Debt Restructurings by Creditors (Subtopic 310-40) Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure*. ASU 2014-04 is intended to reduce diversity in practice by clarifying when an in substance repossession or foreclosure occurs, that is, when a creditor should be considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan such that the loan should be derecognized and the real estate

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property recognized. ASU 2014-04 requires a creditor to reclassify a collateralized consumer mortgage loan to real estate property upon obtaining legal title to the real estate collateral, or the borrower voluntarily conveying all interest in the real estate property to the lender to satisfy the loan through a deed in lieu of foreclosure or similar legal agreement. ASU 2014-04 is effective for public business entities for annual periods, and interim periods within those annual periods, beginning after December 15, 2014. For entities other than public business entities, the amendments in the ASU are effective for annual periods beginning after December 15, 2014, and interim periods within annual periods beginning after December 15, 2015. The adoption of this standard is not expected to have a material effect to the Company's operating results or financial condition.

**Note 2 Securities**

**Investment Portfolio Management**

Our investment portfolio serves the liquidity and income needs of the Company. While the portfolio serves as an important component of the overall liquidity management at the Bank, portions of the portfolio will also serve as income producing assets. The size and composition of the portfolio reflects liquidity needs, loan demand and interest income objectives.

Portfolio size and composition will be adjusted from time to time. While a significant portion of the portfolio consists of readily marketable securities to address liquidity, other parts of the portfolio may reflect funds invested pending future loan demand or to maximize interest income without undue interest rate risk.

Investments are comprised of debt securities and non-marketable equity investments. Securities available-for-sale are carried at fair value. Unrealized gains and losses, net of tax, on securities available-for-sale are reported as a separate component of equity. This balance sheet component changes as interest rates and market conditions change. Unrealized gains and losses are not included in the calculation of regulatory capital.

Securities held-to-maturity are carried at amortized cost and the discount or premium created in the 2013 transfer from available-for-sale securities or at the time of purchase thereafter is accreted or amortized to the maturity or expected payoff date but not an earlier call. In accordance with GAAP, the Company has the positive intent and ability to hold the securities to maturity. The Company has followed and will follow GAAP accounting on all securities holdings.

Nonmarketable equity investments include Federal Home Loan Bank of Chicago ( FHLBC ) stock and Federal Reserve Bank ( Reserve Bank ) stock. FHLBC stock was recorded at a value of \$5.5 million at March 31, 2014, and December 31, 2013. Reserve Bank stock was recorded at \$4.8 million at March 31, 2014, and December 31, 2013. Our FHLBC stock is necessary to maintain our continued access to FHLBC advances.

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The following table summarizes the amortized cost and fair value of securities at March 31, 2014, and December 31, 2013, and the corresponding amounts of gross unrealized gains and losses:

|  | Amortized  | Gross      | Gross      | Fair       |
|--|------------|------------|------------|------------|
|  | Cost       | Unrealized | Unrealized | Value      |
|  | Cost       | Gains      | Losses     | Value      |
| <b>March 31, 2014:</b>                 |            |            |            |            |
| <b>Securities Available-for-Sale</b>   |            |            |            |            |
| U.S. Treasury                          | \$ 1,544   | \$ -       | \$ (4)     | \$ 1,540   |
| U.S. government agencies               | 1,731      | -          | (66)       | 1,665      |
| States and political subdivisions      | 26,215     | 408        | (164)      | 26,459     |
| Corporate bonds                        | 31,625     | 31         | (384)      | 31,272     |
| Collateralized mortgage obligations    | 54,628     | 82         | (3,586)    | 51,124     |
| Asset-backed securities                | 289,583    | 2,465      | (3,896)    | 288,152    |
| Total Securities Available-for-Sale    | \$ 405,326 | \$ 2,986   | \$ (8,100) | \$ 400,212 |
| <b>Securities Held-to-Maturity</b>     |            |            |            |            |
| U.S. government agency mortgage-backed | \$ 35,292  | \$ 634     | \$ -       | \$ 35,926  |
| Collateralized mortgage obligations    | 229,006    | 1,665      | (2,347)    | 228,324    |
| Total Securities Held-to-Maturity      | \$ 264,298 | \$ 2,299   | \$ (2,347) | \$ 264,250 |
|  |            | Gross      | Gross      |            |
|  | Amortized  | Unrealized | Unrealized | Fair Value |
|  | Cost       | Gains      | Losses     | Fair Value |
| <b>December 31, 2013:</b>              |            |            |            |            |
| <b>Securities Available-for-Sale</b>   |            |            |            |            |
| U.S. Treasury                          | \$ 1,549   | \$ -       | \$ (5)     | \$ 1,544   |
| U.S. government agencies               | 1,738      | -          | (66)       | 1,672      |
| States and political subdivisions      | 16,382     | 629        | (217)      | 16,794     |
| Corporate bonds                        | 15,733     | 17         | (648)      | 15,102     |
| Collateralized mortgage obligations    | 66,766     | 256        | (3,146)    | 63,876     |
| Asset-backed securities                | 274,118    | 2,168      | (3,083)    | 273,203    |
| Total Securities Available-for-Sale    | \$ 376,286 | \$ 3,070   | \$ (7,165) | \$ 372,191 |



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**Securities Held-to-Maturity**

|  |            |        |            |            |
|--|------------|--------|------------|------------|
| U.S. government agency mortgage-backed | \$ 35,268  | \$ 45  | \$ (73)    | \$ 35,240  |
| Collateralized mortgage obligations    | 221,303    | 643    | (2,858)    | 219,088    |
| Total Securities Held-to-Maturity      | \$ 256,571 | \$ 688 | \$ (2,931) | \$ 254,328 |

The fair value, amortized cost and weighted average yield of debt securities at March 31, 2014, by contractual maturity, were as follows. Securities not due at a single maturity date, primarily mortgage-backed securities ( MBS ), collateralized mortgage obligations and asset-backed securities, are shown separately. Of note, the Company sold previously owned collateralized debt obligations in late 2013.

|   | Amortized  | Weighted<br>Average | Fair       |
|---|------------|---------------------|------------|
| <b>Securities Available-for-Sale</b>                    | Cost       | Yield               | Value      |
| Due in one year or less                                 | \$ 10,708  | 1.63%               | \$ 10,723  |
| Due after one year through five years                   | 6,233      | 2.97%               | 6,507      |
| Due after five years through ten years                  | 11,887     | 2.90%               | 11,563     |
| Due after ten years                                     | 32,287     | 2.89%               | 32,143     |
|   | 61,115     | 2.68%               | 60,936     |
| Collateralized mortgage obligations                     | 54,628     | 2.41%               | 51,124     |
| Asset-backed securities                                 | 289,583    | 1.48%               | 288,152    |
|   | \$ 405,326 | 1.79%               | \$ 400,212 |
| <b>Securities Held-to-Maturity</b>                      |            |                     |            |
| Mortgage-backed and collateralized mortgage obligations | \$ 264,298 | 3.08%               | \$ 264,250 |

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Securities with unrealized losses at March 31, 2014, and December 31, 2013, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, are as follows (in thousands except for number of securities):

| March 31, 2014                       | Less than 12 months            |            |            | Greater than 12 months         |            |           | Total      |            |            |
|--------------------------------------|--------------------------------|------------|------------|--------------------------------|------------|-----------|------------|------------|------------|
|                                      | in an unrealized loss position |            |            | in an unrealized loss position |            |           |            |            |            |
|                                      | Number of                      | Unrealized | Fair       | Number of                      | Unrealized | Fair      | Number of  | Unrealized | Fair       |
| <b>Securities Available-for-Sale</b> | Securities                     | Losses     | Value      | Securities                     | Losses     | Value     | Securities | Losses     | Value      |
| U.S. Treasury                        | 1                              | \$ 4       | \$ 1,540   | -                              | \$ -       | \$ -      | 1          | \$ 4       | \$ 1,540   |
| U.S. government agencies             | -                              | -          | -          | 1                              | 66         | 1,665     | 1          | 66         | 1,665      |
| States and political subdivisions    | 5                              | 164        | 5,044      | -                              | -          | -         | 5          | 164        | 5,044      |
| Corporate bonds                      | 6                              | 250        | 17,575     | 1                              | 134        | 1,869     | 7          | 384        | 19,444     |
| Collateralized mortgage obligations  | 2                              | 1,323      | 13,127     | 1                              | 2,263      | 21,468    | 3          | 3,586      | 34,595     |
| Asset-backed securities              | 14                             | 2,153      | 98,638     | 2                              | 1,743      | 27,661    | 16         | 3,896      | 126,299    |
|                                      | 28                             | \$ 3,894   | \$ 135,924 | 5                              | \$ 4,206   | \$ 52,663 | 33         | \$ 8,100   | \$ 188,587 |
| <b>Securities Held-to-Maturity</b>   |                                |            |            |                                |            |           |            |            |            |
| Collateralized mortgage obligations  | 14                             | \$ 2,347   | \$ 116,404 | -                              | \$ -       | \$ -      | 14         | \$ 2,347   | \$ 116,404 |
|                                      | 14                             | \$ 2,347   | \$ 116,404 | -                              | \$ -       | \$ -      | 14         | \$ 2,347   | \$ 116,404 |

  

| December 31, 2013                    | Less than 12 months            |            |            | Greater than 12 months         |            |           | Total      |            |            |
|--------------------------------------|--------------------------------|------------|------------|--------------------------------|------------|-----------|------------|------------|------------|
|                                      | in an unrealized loss position |            |            | in an unrealized loss position |            |           |            |            |            |
|                                      | Number of                      | Unrealized | Fair       | Number of                      | Unrealized | Fair      | Number of  | Unrealized | Fair       |
| <b>Securities Available-for-Sale</b> | Securities                     | Losses     | Value      | Securities                     | Losses     | Value     | Securities | Losses     | Value      |
| U.S. Treasury                        | 1                              | \$ 5       | \$ 1,544   | -                              | \$ -       | \$ -      | 1          | \$ 5       | \$ 1,544   |
| U.S. government agencies             | -                              | -          | -          | 1                              | 66         | 1,672     | 1          | 66         | 1,672      |
| States and political subdivisions    | 6                              | 217        | 4,625      | -                              | -          | -         | 6          | 217        | 4,625      |
| Corporate bonds                      | 4                              | 429        | 10,493     | 2                              | 219        | 2,796     | 6          | 648        | 13,289     |
| Collateralized mortgage obligations  | 5                              | 3,146      | 54,021     | -                              | -          | -         | 5          | 3,146      | 54,021     |
| Asset-backed securities              | 11                             | 2,836      | 99,466     | 2                              | 247        | 6,368     | 13         | 3,083      | 105,834    |
|                                      | 27                             | \$ 6,633   | \$ 170,149 | 5                              | \$ 532     | \$ 10,836 | 32         | \$ 7,165   | \$ 180,985 |

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**Securities Held-to-Maturity**

|  |    |          |            |   |      |      |    |          |            |
|--|----|----------|------------|---|------|------|----|----------|------------|
| U.S. government agency mortgage-backed | 6  | \$ 73    | \$ 19,134  | - | \$ - | \$ - | 6  | \$ 73    | \$ 19,134  |
| Collateralized mortgage obligations    | 19 | 2,858    | 156,632    | - | -    | -    | 19 | 2,858    | 156,632    |
|  | 25 | \$ 2,931 | \$ 175,766 | - | \$ - | \$ - | 25 | \$ 2,931 | \$ 175,766 |

Recognition of other-than-temporary impairment was not necessary in the three months ended March 31, 2014, or the year ended December 31, 2013. The changes in fair value related primarily to interest rate fluctuations. Our review of other-than-temporary impairment confirmed no credit quality deterioration.

**Note 3 Loans**

Major classifications of loans were as follows:

|                                 | March 31, 2014 | December 31, 2013 |
|---------------------------------|----------------|-------------------|
| Commercial                      | \$ 98,321      | \$ 94,736         |
| Real estate - commercial        | 579,297        | 560,233           |
| Real estate - construction      | 32,016         | 29,351            |
| Real estate - residential       | 375,781        | 390,201           |
| Consumer                        | 2,837          | 2,760             |
| Overdraft                       | 301            | 628               |
| Lease financing receivables     | 9,227          | 10,069            |
| Other                           | 13,019         | 12,793            |
|                                 | 1,110,799      | 1,100,771         |
| Net deferred loan fees and cost | 438            | 485               |
|                                 | \$ 1,111,237   | \$ 1,101,256      |

It is the policy of the Company to review each prospective credit in order to determine whether an adequate level of security or collateral was obtained prior to making a loan. The type of collateral, when

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required, will vary from liquid assets to real estate. The Company's access to collateral, in the event of borrower default, is assured through adherence to state lending laws, the Company's lending standards and credit monitoring procedures. The Bank generally makes loans solely within its market area. There are no significant concentrations of loans where the customers' ability to honor loan terms is dependent upon a single economic sector although the real estate related categories listed above represent 88.8% and 89.0% of the portfolio at March 31, 2014, and December 31, 2013, respectively.

Aged analysis of past due loans by class of loans were as follows:

| <b>March 31, 2014</b>              |                        |                        |                                   |                   |              |            |              |   |  |
|------------------------------------|------------------------|------------------------|-----------------------------------|-------------------|--------------|------------|--------------|---|--|
|                                    | 30-59 Days<br>Past Due | 60-89 Days<br>Past Due | 90 Days or<br>Greater Past<br>Due | Total Past<br>Due | Current      | Nonaccrual | Total Loans  | Recorded<br>Investment<br>90 days or<br>Greater Past<br>Due and<br>Accruing |  |
| Commercial                         | \$ 254                 | \$ -                   | \$ -                              | \$ 254            | \$ 107,270   | \$ 24      | \$ 107,548   | \$ -  |  |
| Real estate - commercial           |                        |                        |                                   |                   |              |            |              |   |  |
| Owner occupied general purpose     | -                      | -                      | -                                 | -                 | 124,778      | 3,624      | 128,402      | -   |  |
| Owner occupied special purpose     | 247                    | -                      | 472                               | 719               | 163,871      | 7,018      | 171,608      | 472   |  |
| Non-owner occupied general purpose | 400                    | -                      | -                                 | 400               | 129,574      | 7,692      | 137,666      | -   |  |
| Non-owner occupied special purpose | -                      | -                      | -                                 | -                 | 83,172       | 642        | 83,814       | -   |  |
| Retail properties                  | -                      | -                      | -                                 | -                 | 38,373       | 3,071      | 41,444       | -   |  |
| Farm                               | -                      | -                      | -                                 | -                 | 16,363       | -          | 16,363       | -   |  |
| Real estate - construction         |                        |                        |                                   |                   |              |            |              |   |  |
| Homebuilder                        | -                      | -                      | -                                 | -                 | 3,434        | 102        | 3,536        | -   |  |
| Land                               | -                      | -                      | -                                 | -                 | 4,403        | 209        | 4,612        | -   |  |
| Commercial speculative             | -                      | -                      | -                                 | -                 | 13,385       | 1,913      | 15,298       | -   |  |
| All other                          | 73                     | -                      | -                                 | 73                | 7,833        | 664        | 8,570        | -   |  |
| Real estate - residential          |                        |                        |                                   |                   |              |            |              |   |  |
| Investor                           | 1,586                  | 96                     | 223                               | 1,905             | 134,766      | 3,653      | 140,324      | 223   |  |
| Owner occupied                     | 2,676                  | -                      | 430                               | 3,106             | 105,744      | 5,336      | 114,186      | 430   |  |
| Revolving and junior liens         | 325                    | 75                     | -                                 | 400               | 118,145      | 2,726      | 121,271      | -   |  |
| Consumer                           | -                      | -                      | -                                 | -                 | 2,837        | -          | 2,837        | -   |  |
| All other1                         | -                      | -                      | -                                 | -                 | 13,758       | -          | 13,758       | -   |  |
|                                    | \$ 5,561               | \$ 171                 | \$ 1,125                          | \$ 6,857          | \$ 1,067,706 | \$ 36,674  | \$ 1,111,237 | \$ 1,125  |  |

| <b>December 31, 2013</b>           |                        |                        |                                   |                   |            |            |             |   |  |
|------------------------------------|------------------------|------------------------|-----------------------------------|-------------------|------------|------------|-------------|---|--|
|                                    | 30-59 Days<br>Past Due | 60-89 Days<br>Past Due | 90 Days or<br>Greater Past<br>Due | Total Past<br>Due | Current    | Nonaccrual | Total Loans | Recorded<br>Investment<br>90 days or<br>Greater Past<br>Due and<br>Accruing |  |
| Commercial                         | \$ -                   | \$ -                   | \$ -                              | \$ -              | \$ 104,778 | \$ 27      | \$ 104,805  | \$ -  |  |
| Real estate - commercial           |                        |                        |                                   |                   |            |            |             |   |  |
| Owner occupied general purpose     | 290                    | 526                    | -                                 | 816               | 117,938    | 3,180      | 121,934     | -   |  |
| Owner occupied special purpose     | 511                    | -                      | -                                 | 511               | 164,277    | 7,671      | 172,459     | -   |  |
| Non-owner occupied general purpose | 218                    | -                      | -                                 | 218               | 132,331    | 5,708      | 138,257     | -   |  |
|                                    | -                      | -                      | -                                 | -                 | 73,325     | 661        | 73,986      | -   |  |

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|                                    |          |          |       |          |             |           |             |    |    |
|------------------------------------|----------|----------|-------|----------|-------------|-----------|-------------|----|----|
| Non-owner occupied special purpose |          |          |       |          |             |           |             |    |    |
| Retail properties                  | -        | -        | -     | -        | 34,034      | 3,144     | 37,178      | -  | -  |
| Farm                               | -        | -        | -     | -        | 16,419      | -         | 16,419      | -  | -  |
| Real estate - construction         |          |          |       |          |             |           |             |    |    |
| Homebuilder                        | -        | -        | -     | -        | 3,515       | 168       | 3,683       | -  | -  |
| Land                               | -        | -        | -     | -        | 4,436       | 209       | 4,645       | -  | -  |
| Commercial speculative             | -        | -        | -     | -        | 11,235      | 1,913     | 13,148      | -  | -  |
| All other                          | 32       | -        | -     | 32       | 7,404       | 439       | 7,875       | -  | -  |
| Real estate - residential          |          |          |       |          |             |           |             |    |    |
| Investor                           | 581      | 171      | -     | 752      | 140,926     | 6,615     | 148,293     | -  | -  |
| Owner occupied                     | 4,414    | 308      | 87    | 4,809    | 106,184     | 5,967     | 116,960     | 87 | 87 |
| Revolving and junior liens         | 650      | 76       | -     | 726      | 121,013     | 3,209     | 124,948     | -  | -  |
| Consumer                           | 5        | -        | -     | 5        | 2,755       | -         | 2,760       | -  | -  |
| All other <sup>1</sup>             | -        | -        | -     | -        | 13,906      | -         | 13,906      | -  | -  |
|                                    | \$ 6,701 | \$ 1,081 | \$ 87 | \$ 7,869 | \$1,054,476 | \$ 38,911 | \$1,101,256 | \$ | 87 |

1. The All other class includes overdrafts and net deferred loan fees and costs.

**Credit Quality Indicators:**

The Company categorizes loans into credit risk categories based on current financial information, overall debt service coverage, comparison against industry averages, historical payment experience, and current economic trends. Each loan and loan relationship is examined for additional review, if needed. This analysis covers loans with outstanding loans or commitments greater than \$50,000 and excludes

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homogeneous loans such as home equity line of credit and residential mortgages. Loans with a classified risk rating are reviewed quarterly regardless of size or loan type. The Company uses the following definitions for classified risk ratings:

**Special Mention.** Loans classified as special mention have a potential weakness that deserves management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the loan at some future date.

**Substandard.** Loans classified as substandard are inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.

**Doubtful.** Loans classified as doubtful have all the weaknesses inherent in those classified as substandard, with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable.

Credits that are not covered by the definitions above are pass credits, which are not considered to be adversely rated.

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Credit Quality Indicators by class of loans were as follows:

**March 31, 2014**

|                                    | Pass         | Special<br>Mention | Substandard 1 | Doubtful | Total        |
|------------------------------------|--------------|--------------------|---------------|----------|--------------|
| Commercial                         | \$ 99,815    | \$ 7,278           | \$ 455        | \$ -     | \$ 107,548   |
| Real estate - commercial           |              |                    |               |          |              |
| Owner occupied general purpose     | 117,120      | 6,215              | 5,067         | -        | 128,402      |
| Owner occupied special purpose     | 163,134      | 1,231              | 7,243         | -        | 171,608      |
| Non-owner occupied general purpose | 123,330      | 3,556              | 10,780        | -        | 137,666      |
| Non-owner occupied special purpose | 73,389       | 9,783              | 642           | -        | 83,814       |
| Retail Properties                  | 34,568       | 2,975              | 3,901         | -        | 41,444       |
| Farm                               | 16,363       | -                  | -             | -        | 16,363       |
| Real estate - construction         |              |                    |               |          |              |
| Homebuilder                        | 3,434        | -                  | 102           | -        | 3,536        |
| Land                               | 4,403        | -                  | 209           | -        | 4,612        |
| Commercial speculative             | 9,843        | -                  | 5,455         | -        | 15,298       |
| All other                          | 7,876        | 30                 | 664           | -        | 8,570        |
| Real estate - residential          |              |                    |               |          |              |
| Investor                           | 131,509      | 1,141              | 7,674         | -        | 140,324      |
| Owner occupied                     | 107,339      | -                  | 6,847         | -        | 114,186      |
| Revolving and junior liens         | 117,238      | 388                | 3,645         | -        | 121,271      |
| Consumer                           | 2,837        | -                  | -             | -        | 2,837        |
| All other                          | 13,758       | -                  | -             | -        | 13,758       |
| Total                              | \$ 1,025,956 | \$ 32,597          | \$ 52,684     | \$ -     | \$ 1,111,237 |

**December 31, 2013**

|                                    | Pass       | Special<br>Mention | Substandard 1 | Doubtful | Total        |
|------------------------------------|------------|--------------------|---------------|----------|--------------|
| Commercial                         | \$ 96,371  | \$ 7,953           | \$ 481        | \$ -     | \$ 104,805   |
| Real estate - commercial           |            |                    |               |          |              |
| Owner occupied general purpose     | 105,683    | 9,048              | 7,203         | -        | 121,934      |
| Owner occupied special purpose     | 162,586    | 1,968              | 7,905         | -        | 172,459      |
| Non-owner occupied general purpose | 122,844    | 1,826              | 13,587        | -        | 138,257      |
| Non-owner occupied special purpose | 59,674     | 9,840              | 4,472         | -        | 73,986       |
| Retail Properties                  | 30,059     | 2,989              | 4,130         | -        | 37,178       |
| Farm                               | 16,419     | -                  | -             | -        | 16,419       |
| Real estate - construction         |            |                    |               |          |              |
| Homebuilder                        | 1,745      | 1,770              | 168           | -        | 3,683        |
| Land                               | 4,436      | -                  | 209           | -        | 4,645        |
| Commercial speculative             | 7,674      | 3,561              | 1,913         | -        | 13,148       |
| All other                          | 7,109      | 32                 | 734           | -        | 7,875        |
| Real estate - residential          |            |                    |               |          |              |
| Investor                           | 135,136    | 3,407              | 9,750         | -        | 148,293      |
| Owner occupied                     | 109,261    | -                  | 7,699         | -        | 116,960      |
| Revolving and junior liens         | 120,589    | 388                | 3,971         | -        | 124,948      |
| Consumer                           | 2,759      | -                  | 1             | -        | 2,760        |
| All other                          | 13,906     | -                  | -             | -        | 13,906       |
| Total                              | \$ 996,251 | \$ 42,782          | \$ 62,223     | \$ -     | \$ 1,101,256 |

- 1 The substandard credit quality indicator includes both potential problem loans that are currently performing and nonperforming loans.



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Impaired loans by class of loan were as follows:

|   | As of March 31, 2014   |                                |                      | Quarter Ended<br>March 31, 2014   |                                  |
|---|------------------------|--------------------------------|----------------------|-----------------------------------|----------------------------------|
|   | Recorded<br>Investment | Unpaid<br>Principal<br>Balance | Related<br>Allowance | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized |
| <b>With no related allowance recorded</b>       |                        |                                |                      |                                   |                                  |
| Commercial                                      | \$ 24                  | \$ 32                          | \$ -                 | \$ 26                             | \$ -                             |
| Commercial real estate                          |                        |                                |                      |                                   |                                  |
| Owner occupied general purpose                  | 2,592                  | 3,144                          | -                    | 2,567                             | 1                                |
| Owner occupied special purpose                  | 4,869                  | 6,147                          | -                    | 4,120                             | -                                |
| Non-owner occupied general purpose              | 8,345                  | 9,821                          | -                    | 6,886                             | 15                               |
| Non-owner occupied special purpose              | 642                    | 909                            | -                    | 652                               | -                                |
| Retail properties                               | 3,071                  | 3,738                          | -                    | 3,107                             | -                                |
| Farm  | -                      | -                              | -                    | -                                 | -                                |
| Construction                                    |                        |                                |                      |                                   |                                  |
| Homebuilder                                     | 1,893                  | 2,395                          | -                    | 1,955                             | 28                               |
| Land  | 209                    | 310                            | -                    | 209                               | -                                |
| Commercial speculative                          | 1,913                  | 2,550                          | -                    | 1,325                             | -                                |
| All other                                       | 295                    | 326                            | -                    | 150                               | -                                |
| Residential                                     |                        |                                |                      |                                   |                                  |
| Investor  | 3,362                  | 5,007                          | -                    | 4,673                             | 1                                |
| Owner occupied                                  | 10,000                 | 11,429                         | -                    | 9,589                             | 47                               |
| Revolving and junior liens                      | 2,288                  | 3,286                          | -                    | 2,030                             | 1                                |
| Consumer  | -                      | -                              | -                    | -                                 | -                                |
| Total impaired loans with no recorded allowance | 39,503                 | 49,094                         | -                    | 37,289                            | 93                               |
| <b>With an allowance recorded</b>               |                        |                                |                      |                                   |                                  |
| Commercial                                      | -                      | -                              | -                    | -                                 | -                                |
| Commercial real estate                          |                        |                                |                      |                                   |                                  |
| Owner occupied general purpose                  | 1,122                  | 1,152                          | 462                  | 926                               | -                                |
| Owner occupied special purpose                  | 2,149                  | 2,342                          | 211                  | 3,225                             | -                                |
| Non-owner occupied general purpose              | -                      | -                              | -                    | 469                               | -                                |
| Non-owner occupied special purpose              | -                      | -                              | -                    | -                                 | -                                |
| Retail properties                               | -                      | -                              | -                    | -                                 | -                                |
| Farm  | -                      | -                              | -                    | -                                 | -                                |
| Construction                                    |                        |                                |                      |                                   |                                  |
| Homebuilder                                     | -                      | -                              | -                    | 84                                | -                                |
| Land  | -                      | -                              | -                    | -                                 | -                                |
| Commercial speculative                          | -                      | -                              | -                    | 588                               | -                                |
| All other                                       | 369                    | 400                            | 194                  | 402                               | -                                |
| Residential                                     |                        |                                |                      |                                   |                                  |

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|  |           |           |          |           |       |
|--|-----------|-----------|----------|-----------|-------|
| Investor                                       | 344       | 419       | 130      | 514       | -     |
| Owner occupied                                 | 214       | 276       | 30       | 890       | 2     |
| Revolving and junior liens                     | 497       | 560       | 220      | 997       | -     |
| Consumer                                       | -         | -         | -        | -         | -     |
| Total impaired loans with a recorded allowance | 4,695     | 5,149     | 1,247    | 8,095     | 2     |
| Total impaired loans                           | \$ 44,198 | \$ 54,243 | \$ 1,247 | \$ 45,384 | \$ 95 |

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Impaired loans by class of loans were as follows:

|   | As of December 31, 2013 |                                |                      | Quarter Ended<br>March 31, 2013   |                                  |
|---|-------------------------|--------------------------------|----------------------|-----------------------------------|----------------------------------|
|   | Recorded<br>Investment  | Unpaid<br>Principal<br>Balance | Related<br>Allowance | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized |
| <b>With no related allowance recorded</b>       |                         |                                |                      |                                   |                                  |
| Commercial                                      | \$ 27                   | \$ 34                          | \$ -                 | \$ 169                            | \$ -                             |
| Commercial real estate                          |                         |                                |                      |                                   |                                  |
| Owner occupied general purpose                  | 2,543                   | 3,006                          | -                    | 4,333                             | 1                                |
| Owner occupied special purpose                  | 3,371                   | 4,117                          | -                    | 5,855                             | -                                |
| Non-owner occupied general purpose              | 5,428                   | 6,709                          | -                    | 12,797                            | 44                               |
| Non-owner occupied special purpose              | 661                     | 919                            | -                    | 472                               | -                                |
| Retail properties                               | 3,144                   | 3,811                          | -                    | 7,031                             | -                                |
| Farm  | -                       | -                              | -                    | 2,467                             | -                                |
| Construction                                    |                         |                                |                      |                                   |                                  |
| Homebuilder                                     | 2,016                   | 2,016                          | -                    | 3,876                             | 31                               |
| Land  | 209                     | 308                            | -                    | 127                               | -                                |
| Commercial speculative                          | 738                     | 742                            | -                    | 2,126                             | -                                |
| All other                                       | 4                       | 35                             | -                    | 66                                | -                                |
| Residential                                     |                         |                                |                      |                                   |                                  |
| Investor  | 5,984                   | 8,338                          | -                    | 6,437                             | -                                |
| Owner occupied                                  | 9,179                   | 10,451                         | -                    | 9,425                             | 57                               |
| Revolving and junior liens                      | 1,771                   | 2,313                          | -                    | 1,300                             | 1                                |
| Consumer  | -                       | -                              | -                    | 11                                | -                                |
| Total impaired loans with no recorded allowance | 35,075                  | 42,799                         | -                    | 56,492                            | 134                              |
| <b>With an allowance recorded</b>               |                         |                                |                      |                                   |                                  |
| Commercial                                      | -                       | -                              | -                    | 317                               | -                                |
| Commercial real estate                          |                         |                                |                      |                                   |                                  |
| Owner occupied general purpose                  | 730                     | 792                            | 264                  | 956                               | -                                |
| Owner occupied special purpose                  | 4,300                   | 4,702                          | 759                  | 5,090                             | -                                |
| Non-owner occupied general purpose              | 939                     | 1,030                          | 129                  | 2,649                             | -                                |
| Non-owner occupied special purpose              | -                       | -                              | -                    | 501                               | -                                |
| Retail properties                               | -                       | -                              | -                    | 2,658                             | -                                |
| Farm  | -                       | -                              | -                    | -                                 | -                                |
| Construction                                    |                         |                                |                      |                                   |                                  |
| Homebuilder                                     | 168                     | 604                            | 76                   | 13                                | -                                |
| Land  | -                       | -                              | -                    | 127                               | -                                |
| Commercial speculative                          | 1,175                   | 1,808                          | 17                   | 3,844                             | -                                |
| All other                                       | 436                     | 468                            | 262                  | 516                               | -                                |
| Residential                                     |                         |                                |                      |                                   |                                  |
| Investor  | 684                     | 913                            | 160                  | 2,779                             | -                                |
| Owner occupied                                  | 1,565                   | 1,831                          | 170                  | 4,927                             | 6                                |
| Revolving and junior liens                      | 1,498                   | 1,848                          | 558                  | 2,448                             | -                                |
| Consumer  | -                       | -                              | -                    | -                                 | -                                |

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|  |           |           |          |           |        |
|--|-----------|-----------|----------|-----------|--------|
| Total impaired loans with a recorded allowance | 11,495    | 13,996    | 2,395    | 26,825    | 6      |
| Total impaired loans                           | \$ 46,570 | \$ 56,795 | \$ 2,395 | \$ 83,317 | \$ 140 |

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Troubled debt restructurings ( TDR ) are loans for which the contractual terms have been modified and both of these conditions exist: (1) there is a concession to the borrower and (2) the borrower is experiencing financial difficulties. Loans are restructured on a case-by-case basis during the loan collection process with modifications generally initiated at the request of the borrower. These modifications may include a reduction in interest rates, extension of term, deferral of principal, and other modifications. The Bank does participate in the U.S. Department of the Treasury s (the Treasury ) Home Affordable Modification Program ( HAMP ), which gives qualifying homeowners an opportunity to refinance into more affordable monthly payments.

The specific allocation of the allowance for loan losses on TDRs is determined either by discounting the modified cash flows at the original effective rate of the loan before modification or is based on the underlying collateral value less costs to sell if repayment of the loan is collateral-dependent. If the resulting amount is less than the recorded book value, the Bank either establishes a valuation allowance (i.e. specific reserve) as a component of the allowance for loan losses or charges off the impaired balance if it determines that such amount is a confirmed loss. This method is used consistently for all segments of the portfolio. The allowance for loan losses also includes an allowance based on a loss migration analysis for each loan category for loans that are not individually evaluated for specific impairment. All loans charged-off, including TDRs charged-off, are factored into this calculation by portfolio segment.

TDRs that were modified during the period are summarized as follows:

TDR Modifications  
Three months ending March 31, 2014

|                                     | # of<br>contracts | Pre-modification<br>recorded investment | Post-modification<br>recorded investment |
|-------------------------------------|-------------------|---|--|
| <b>Troubled debt restructurings</b> |                   |   |  |
| Real estate - commercial            |                   |   |  |
| Other1                              | 2                 | \$ 1,320                                | \$ 1,191                                 |
| Real estate - residential           |                   |   |  |
| Owner occupied                      |                   |   |  |
| HAMP2                               | 1                 | 102                                     | 76                                       |
| Deferral3                           | 1                 | 237                                     | 127                                      |
|                                     | 4                 | \$ 1,659                                | \$ 1,394                                 |

TDR Modifications  
Three months ending March 31, 2013

|                                     | # of<br>contracts | Pre-modification<br>recorded investment | Post-modification<br>recorded investment |
|-------------------------------------|-------------------|---|--|
| <b>Troubled debt restructurings</b> |                   |   |  |
| Real estate - residential           |                   |   |  |
| Owner occupied                      |                   |   |  |
| Deferral3                           | 1                 | \$ 137                                  | \$ 137                                   |
|                                     | 1                 | \$ 137                                  | \$ 137                                   |

1 Other: Change of terms from bankruptcy court

2 HAMP: Home Affordable Modification Program

3 Deferral: Refers to the deferral of principal

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TDRs are classified as being in default when they fail to be in compliance with the modified terms. The following table presents TDRs that defaulted during the periods shown and were restructured within the 12 month period prior to default. There was no TDR default activity for the three months ending March 31, 2014.

| Troubled debt restructurings that<br>Subsequently Defaulted<br>Real estate - residential<br>Investor | TDR Default Activity<br>Three Months ending 3/31/14 |   |   | TDR Default Activity<br>Three Months ending 3/31/13 |   |     |
|--|---|---|---|---|---|-----|
|  | # of<br>contracts                                   | Pre-modification outstanding<br>recorded investment |   | # of<br>contracts                                   | Pre-modification outstanding<br>recorded investment |     |
|  | -   | \$  | - | 1   | \$  | 155 |
|  | -   | \$  | - | 1   | \$  | 155 |

**Note 4 Allowance for Loan Losses**

Changes in the allowance for loan losses by segment of loans based on method of impairment for the three months ended March 31, 2014, were as follows:

|   | Commercial | Real Estate<br>Commercial I | Real Estate<br>Construction | Real Estate<br>Residential | Consumer | Unallocated | Total        |
|---|------------|-----------------------------|-----------------------------|----------------------------|----------|-------------|--------------|
| <b>Allowance for loan losses:</b>                           |            |                             |                             |                            |          |             |              |
| Beginning balance   | \$ 2,250   | \$ 16,763                   | \$ 1,980                    | \$ 2,837                   | \$ 1,439 | \$ 2,012    | \$27,281     |
| Charge-offs   | 4          | 329                         | 68                          | 849                        | 110      | -           | 1,360        |
| Recoveries  | 15         | 141                         | 37                          | 250                        | 112      | -           | 555          |
| Provision (release)   | 65         | (2,509)                     | 49                          | 30                         | 54       | 1,311       | (1,000)      |
| Ending balance  | \$ 2,326   | \$ 14,066                   | \$ 1,998                    | \$ 2,268                   | \$ 1,495 | \$ 3,323    | \$ 25,476    |
| Ending balance:<br>Individually evaluated for<br>impairment | \$ -       | \$ 673                      | \$ 194                      | \$ 380                     | \$ -     | \$ -        | \$ 1,247     |
| Ending balance:<br>Collectively evaluated for<br>impairment | \$ 2,326   | \$ 13,393                   | \$ 1,804                    | \$ 1,888                   | \$ 1,495 | \$ 3,323    | \$ 24,229    |
| <b>Financing receivables:</b>                               |            |                             |                             |                            |          |             |              |
| Ending balance  | \$ 107,548 | \$ 579,297                  | \$ 32,016                   | \$ 375,781                 | \$ 2,837 | \$ 13,758   | \$ 1,111,237 |
| Ending balance:<br>Individually evaluated for<br>impairment | \$ 24      | \$ 22,790                   | \$ 4,679                    | \$ 16,705                  | \$ -     | \$ -        | \$ 44,198    |
| Ending balance:<br>Collectively evaluated for<br>impairment | \$ 107,524 | \$ 556,507                  | \$ 27,337                   | \$ 359,076                 | \$ 2,837 | \$ 13,758   | \$ 1,067,039 |

1 As of March 31, 2014, this segment consisted of performing loans that included a higher risk pool of loans rated as substandard that totaled \$5.6 million. The amount of general allocation that was estimated for that portion of these performing substandard rated loans was \$412,000 at March 31, 2014.

The Company's allowance for loan loss is calculated in accordance with GAAP and relevant supervisory guidance. All management estimates were made in light of observable trends within the loan portfolio segments, market conditions and established credit review administration practices.



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Changes in the allowance for loan losses by segment of loans based on method of impairment for the quarter ended March 31, 2013, were as follows:

|                                       | Commercial | Real Estate<br>Commercial <sup>1</sup> | Real Estate<br>Construction | Real Estate<br>Residential | Consumer | Unallocated | Total        |
|---------------------------------------|------------|--|-----------------------------|----------------------------|----------|-------------|--------------|
| <b>Allowance for loan losses:</b>     |            |  |                             |                            |          |             |              |
| Beginning balance                     | \$ 4,517   | \$ 20,100                              | \$ 3,837                    | \$ 4,535                   | \$ 1,178 | \$ 4,430    | \$ 38,597    |
| Charge-offs                           | 254        | 508                                    | 4                           | 585                        | 172      | -           | 1,523        |
| Recoveries                            | 19         | 2,724                                  | 770                         | 404                        | 143      | -           | 4,060        |
| (Release) provision                   | (509)      | (3,051)                                | (874)                       | (383)                      | 65       | 2,252       | (2,500)      |
| Ending balance                        | \$ 3,773   | \$ 19,265                              | \$ 3,729                    | \$ 3,971                   | \$ 1,214 | \$ 6,682    | \$ 38,634    |
| Ending balance:                       |            |  |                             |                            |          |             |              |
| Individually evaluated for impairment | \$ 68      | \$ 2,000                               | \$ 1,039                    | \$ 1,931                   | \$ -     | \$ -        | \$ 5,038     |
| Ending balance:                       |            |  |                             |                            |          |             |              |
| Collectively evaluated for impairment | \$ 3,705   | \$ 17,265                              | \$ 2,690                    | \$ 2,040                   | \$ 1,214 | \$ 6,682    | \$ 33,596    |
| <b>Financing receivables:</b>         |            |  |                             |                            |          |             |              |
| Ending balance                        | \$ 92,906  | \$ 566,349                             | \$ 40,698                   | \$ 394,599                 | \$ 2,908 | \$ 15,842   | \$ 1,113,302 |
| Ending balance:                       |            |  |                             |                            |          |             |              |
| Individually evaluated for impairment | \$ 210     | \$ 42,036                              | \$ 9,810                    | \$ 25,593                  | \$ -     | \$ -        | \$ 77,649    |
| Ending balance:                       |            |  |                             |                            |          |             |              |
| Collectively evaluated for impairment | \$ 92,696  | \$ 524,313                             | \$ 30,888                   | \$ 369,006                 | \$ 2,908 | \$ 15,842   | \$ 1,035,653 |

<sup>1</sup> As of March 31, 2013, this segment consisted of performing loans that included a higher risk pool of loans rated as substandard that totaled \$21.8 million. The amount of general allocation that was estimated for that portion of these performing substandard rated loans was \$3.1 million at March 31, 2013.

**Note 5 Other Real Estate Owned**

Details related to the activity in the other real estate owned ( OREO ) portfolio, net of valuation reserve, for the periods presented are itemized in the following table:

|                                | Three Months Ended<br>March 31, |           |
|--------------------------------|---------------------------------|-----------|
|                                | 2014                            | 2013      |
| Balance at beginning of period | \$ 41,537                       | \$ 72,423 |
| Property additions             | 4,688                           | 6,985     |
| Development improvements       | -                               | 50        |
| Less:                          |                                 |           |

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|   |           |           |
|---|-----------|-----------|
| Property disposals, net of gains/losses | 5,569     | 11,661    |
| Period valuation adjustments            | 436       | 2,134     |
| Other real estate owned                 | \$ 40,220 | \$ 65,663 |

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Activity in the valuation allowance was as follows:

|                                 | Three Months Ended<br>March 31, |           |
|---------------------------------|---------------------------------|-----------|
|                                 | 2014                            | 2013      |
| Balance at beginning of period  | \$ 22,284                       | \$ 31,454 |
| Provision for unrealized losses | 436                             | 1,987     |
| Reductions taken on sales       | (2,647)                         | (2,622)   |
| Other adjustments               | (589)                           | 147       |
| Balance at end of period        | \$ 19,484                       | \$ 30,966 |

Expenses related to foreclosed assets, net of lease revenue includes:

|                                 | Three Months Ended<br>March 31, |          |
|---------------------------------|---------------------------------|----------|
|                                 | 2014                            | 2013     |
| Gain on sales, net              | \$ (386)                        | \$ (181) |
| Provision for unrealized losses | 436                             | 1,987    |
| Operating expenses              | 1,237                           | 1,699    |
| Less:                           |                                 |          |
| Lease revenue                   | 279                             | 408      |
|                                 | \$ 1,008                        | \$ 3,097 |

**Note 6 Deposits**

Major classifications of deposits were as follows:

|  | March 31, 2014 | December 31, 2013 |
|--|----------------|-------------------|
| Noninterest bearing demand                     | \$ 387,090     | \$ 373,389        |
| Savings  | 244,944        | 228,589           |
| NOW accounts                                   | 309,385        | 297,852           |
| Money market accounts                          | 318,192        | 309,859           |
| Certificates of deposit of less than \$100,000 | 282,569        | 288,345           |
| Certificates of deposit of \$100,000 or more   | 182,101        | 184,094           |
|  | \$ 1,724,281   | \$ 1,682,128      |

Table of Contents**Note 7 Borrowings**

The following table is a summary of borrowings as of March 31, 2014, and December 31, 2013. Junior subordinated debentures are discussed in detail in Note 8:

|   | March 31, 2014 |         | December 31, 2013 |         |
|---|----------------|---------|-------------------|---------|
| Securities sold under repurchase agreements | \$             | 23,212  | \$                | 22,560  |
| FHLBC advances                              |                | 20,000  |                   | 5,000   |
| Junior subordinated debentures              |                | 58,378  |                   | 58,378  |
| Subordinated debt                           |                | 45,000  |                   | 45,000  |
| Notes payable and other borrowings          |                | 500     |                   | 500     |
|   | \$             | 147,090 | \$                | 131,438 |

The Company enters into deposit sweep transactions where the transaction amounts are secured by pledged securities. These transactions consistently mature within 1 to 90 days from the transaction date and are governed by sweep repurchase agreements. All sweep repurchase agreements are treated as financings secured by U. S. government agencies and collateralized mortgage-backed securities and had a carrying amount of \$23.2 million at March 31, 2014, and \$22.6 million at December 31, 2013. The fair value of the pledged collateral was \$38.8 million and \$39.2 million at March 31, 2014 and December 31, 2013, respectively. At March 31, 2014, there were no customers with secured balances exceeding 10% of stockholders' equity.

The Company's borrowings at the FHLBC require the Bank to be a member and invest in the stock of the FHLBC and total borrowings are generally limited to the lower of 35% of total assets or 60% of the book value of certain mortgage loans. As of March 31, 2014, the Bank took an advance of \$20.0 million at 0.13% interest on the FHLBC stock valued at \$5.5 million and collateralized by securities with a fair value of \$75.8 million and loans with a principal balance of \$55.3 million, which carry a combined collateral value of \$110.4 million. This advance matured on April 1, 2014, and was repaid according to its terms. The Company still has excess collateral value of \$89.1 million available to secure additional borrowings.

One of the Company's most significant borrowing relationships continued to be the \$45.5 million credit facility with a correspondent bank. That credit began in January 2008 and was originally composed of a \$30.5 million senior debt facility, which included \$500,000 in term debt and \$45.0 million of subordinated debt. The subordinated debt and the term debt portion of the senior debt facility mature on March 31, 2018. The interest rate on the senior debt facility resets quarterly and, at the Company's option, is based on either the lender's prime rate or three-month LIBOR plus 90 basis points. The interest rate on the subordinated debt resets quarterly and is equal to three-month LIBOR plus 150 basis points. The Company had no principal outstanding balance on the senior line of credit when it matured. The Company terminated the senior line of credit. The Company had \$500,000 in principal outstanding in term debt and \$45.0 million in principal outstanding in subordinated debt at March 31, 2014 and December 31, 2013. The term debt is secured by all of the outstanding capital stock of the Bank. The Company has made all required interest payments on the outstanding principal amounts on a timely basis. Pursuant to the Written Agreement (the "Written Agreement") the Company entered into with the Reserve Bank, the Company was required to receive the Reserve Bank's approval prior to making any interest payments on the subordinated debt. In January 2014, the Reserve Bank notified the Company that the Written Agreement was terminated.

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The agreement governing the credit facility contains usual and customary provisions regarding acceleration of the senior debt upon the occurrence of an event of default by the Company. The senior debt agreement also contains certain customary representations and warranties and financial covenants. At March 31, 2014, the Company was out of compliance with one of the financial covenants contained within the credit agreement. Prior to 2013, the Company had been out of compliance with two of the financial covenants. The agreement provides that noncompliance is an event of default and as the result

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of the Company's failure to comply with a financial covenant, the lender may (i) terminate all commitments to extend further credit, (ii) increase the interest rate on the revolving line of the term debt by 200 basis points, (iii) declare the senior debt immediately due and payable and (iv) exercise all of its rights and remedies at law, in equity and/or pursuant to any or all collateral documents, including foreclosing on the collateral. However, the total outstanding principal amount of the senior debt is the \$500,000 in term debt, and because the subordinated debt is treated as Tier 2 capital, the agreement does not provide the lender with any additional rights of acceleration or other remedies upon an event of default caused by the Company's failure to comply with a financial covenant.

**Note 8 Junior Subordinated Debentures**

The Company completed the sale of \$27.5 million of cumulative trust preferred securities by its unconsolidated subsidiary, Old Second Capital Trust I, in June 2003. An additional \$4.1 million sale of cumulative trust preferred securities closed in July 2003. The trust preferred securities may remain outstanding for a 30-year term but, subject to regulatory approval, can be called in whole or in part by the Company after June 30, 2008. When not in deferral, distributions on the securities are payable quarterly at an annual rate of 7.80%. The Company issued a new \$32.6 million subordinated debenture to the trust in return for the aggregate net proceeds of this trust preferred offering. The interest rate and payment frequency on the debenture are equivalent to the cash distribution basis on the trust preferred securities.

The Company issued an additional \$25.0 million of cumulative trust preferred securities through a private placement completed by an additional unconsolidated subsidiary, Old Second Capital Trust II, in April 2007. These trust preferred securities also mature in 30 years, but subject to the aforementioned regulatory approval, can be called in whole or in part, on a quarterly basis commencing June 15, 2017. The quarterly cash distributions on the securities are fixed at 6.77% through June 15, 2017 and float at 150 basis points over three-month LIBOR thereafter. The Company issued a new \$25.8 million subordinated debenture to the Old Second Capital Trust II in return for the aggregate net proceeds of this trust preferred offering. The interest rate and payment frequency on the debenture are equivalent to the cash distribution basis on the trust preferred securities.

Under the terms of the subordinated debentures issued to each of Old Second Capital Trust I and II, the Company can elect to defer interest payments for 20 quarterly periods without default or penalty, but such amounts will continue to accrue. Also during the deferral period, the Company generally may not pay cash dividends on or repurchase its common stock or preferred stock, including the Series B Fixed Rate Cumulative Perpetual Preferred Stock (the Series B Stock) as discussed in Note 15. In August of 2010, the Company elected to defer regularly scheduled interest payments on the \$58.4 million of junior subordinated debentures. Because of the deferral on the subordinated debentures, the trusts deferred regularly scheduled dividends on the trust preferred securities. On April 21, 2014, the Company paid all outstanding interest on the trust preferred securities to the trustees for payment to holders as of the next record date set forth in the indentures and terminated the deferral period. Both of the debentures issued by the Company are disclosed on the Consolidated Balance Sheet as junior subordinated debentures and the related interest expense for each issuance is included in the Consolidated Statements of Income. The total accumulated unpaid interest on the junior subordinated debentures including compounded interest from July 1, 2010 on the deferred payments, totaled \$18.4 million at March 31, 2014. In order to terminate the deferral period, the Company paid all accumulated and unpaid interest on the trust preferred securities through the next payment date set forth in the indentures, which totaled \$19.7 million.

**Note 9 - Long-Term Incentive Plan**

The Long-Term Incentive Plan (the Incentive Plan) authorizes the issuance of up to 1,908,332 shares of the Company's common stock, including the granting of qualified stock options, non-qualified stock options, restricted stock, restricted stock units, and stock appreciation rights. Total shares issuable under the plan were 45,368 at March 31, 2014. Stock based awards may be granted to selected directors and officers or

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employees at the discretion of the board of directors. There were no stock options granted in the first quarter of 2014 or 2013. All stock options are granted for a term of ten years.

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Total compensation cost that has been charged for those plans was \$66,000 in the first quarter of 2014 and \$14,000 in the first quarter of 2013.

There were no stock options exercised during the first quarter of 2014 or 2013. There is no unrecognized compensation cost related to nonvested stock options of the Company's common stock as of March 31, 2014.

A summary of stock option activity in the Incentive Plan is as follows for the quarter ended March 31, 2014:

| <b>March 31, 2014</b>         | Shares  | Weighted<br>Average<br>Exercise<br>Price | Weighted-<br>Average<br>Remaining<br>Contractual<br>Term (years) | Aggregate<br>Intrinsic<br>Value |
|-------------------------------|---------|--|--|---------------------------------|
| Beginning outstanding         | 325,500 | \$ 29.56                                 |  |                                 |
| Canceled                      | -       | -  |  |                                 |
| Ending outstanding            | 325,500 | \$ 29.56                                 | 2.3  | \$ -                            |
| Exercisable at end of quarter | 325,500 | \$ 29.56                                 | 2.3  | \$ -                            |

Generally, restricted stock and restricted stock units vest three years from the grant date, but the Company's Board of Directors has discretionary authority to change some terms including the amount of time until the vest date. Awards under the Incentive Plan are fully vested upon a merger or change in control of the Company.

Under the Incentive Plan, restricted stock was granted beginning in 2005 and the grant of restricted units began in February 2009. Both of these restricted awards have voting and dividend rights and are subject to forfeiture until certain restrictions have lapsed including employment for a specific period. There were no restricted awards issued during the first quarter of 2014 or during the first quarter of 2013. Compensation expense is recognized over the vesting period of the restricted award based on the market value of the award at the date of issuance.

A summary of changes in the Company's nonvested restricted awards follows for the quarter ended March 31, 2014:

|                        | Restricted<br>Stock Shares<br>and Units | March 31, 2014<br>Weighted<br>Average<br>Grant Date<br>Fair Value |
|------------------------|---|---|
| Nonvested at January 1 | 185,500                                 | \$ 2.95   |
| Granted                | -                                       | -   |
| Vested                 | (25,000)                                | 2.06  |
| Forfeited              | -                                       | -   |



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Nonvested at March 31

160,500 \$

3.09

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The total unrecognized compensation cost of restricted awards is \$303,000 as of March 31, 2014. The Company expects to recognize this cost over a weighted-average period of 1.99 years. The total unrecognized compensation cost of restricted awards was \$31,000 as of March 31, 2013. The Company expects to recognize this cost over a weighted-average period of 0.81 years.

**Note 10 Earnings Per Share**

Earnings per share is included below as of March 31 (in thousands except for share data):

|   | Three Months Ended<br>March 31, |            |
|---|---------------------------------|------------|
|   | 2014                            | 2013       |
| Basic earnings per share:   |                                 |            |
| Weighted-average common shares outstanding  | 13,921,023                      | 14,076,114 |
| Weighted-average common shares less stock based awards                                  | 13,912,523                      | 13,947,454 |
| Weighted-average common shares stock based awards                                       | 169,111                         | 210,069    |
| Net earnings  | \$ 2,202                        | \$ 5,471   |
| Dividend and accretion on preferred shares  | 1,572                           | 1,289      |
| Net earnings available to common stockholders   | 630                             | 4,182      |
| Common stock dividends  | -                               | -          |
| Un-vested share-based payment awards  | -                               | -          |
| Undistributed earnings  | 630                             | 4,182      |
| Basic earnings per share common undistributed earnings                                  | 0.04                            | 0.30       |
| Basic earnings per share of common stock  | \$ 0.04                         | \$ 0.30    |
| Diluted earnings per share:   |                                 |            |
| Weighted-average common shares outstanding  | 13,921,023                      | 14,076,114 |
| Dilutive effect of nonvested restricted awards <sup>1</sup>                             | 160,611                         | 81,409     |
| Diluted average common shares outstanding   | 14,081,634                      | 14,157,523 |
| Net earnings available to common stockholders   | \$ 630                          | \$ 4,182   |
| Diluted earnings per share  | \$ 0.04                         | \$ 0.30    |
| Number of antidilutive options excluded from the diluted earnings per share calculation | 1,140,839                       | 1,224,839  |

<sup>1</sup> Includes the common stock equivalents for restricted share rights that are dilutive.

The above earnings per share calculation did not include a warrant for 815,339 shares of common stock that was outstanding as of March 31, 2014, and March 31, 2013 because they were anti-dilutive. Of note, the warrant was sold at auction by the U.S. Treasury in June, 2013.

**Note 11 - Regulatory & Capital Matters**

The Bank is subject to the risk-based capital regulatory guidelines, which include the methodology for calculating the risk-weighted Bank assets, developed by the Office of the Comptroller of the Currency (the OCC) and the other bank regulatory agencies. In connection with the current economic environment, the Bank's current level of nonperforming assets and the risk-based capital guidelines, the Bank's board of directors has determined that the Bank should maintain a Tier 1 leverage capital ratio at or above eight percent (8%) and a total risk-based capital ratio at or above twelve percent (12%). The Bank currently exceeds those thresholds.

The Bank exceeded both board of directors' capital ratio objectives. At March 31, 2014, the Bank's Tier 1 capital leverage ratio was 11.12%, up 15 basis points from December 31, 2013 and well above the 8.00% objective. The Bank's total capital ratio was 17.83%, down 21 basis points from December 31, 2013, and also well above the 12.00% objective.

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On July 22, 2011, the Company entered into a Written Agreement with the Reserve Bank designed to maintain the financial soundness of the Company. Pursuant to the Written Agreement, the Company took certain actions and operated in compliance with the Written Agreement's provisions during its term. On January 17, 2014, the Reserve Bank terminated the Written Agreement. Although the Written Agreement has been terminated, the Company expects that it will continue to seek approval from the Reserve Bank prior to paying any dividends on its capital stock and incurring any additional indebtedness.

Bank holding companies are required to maintain minimum levels of capital in accordance with Reserve Bank capital guidelines. The general bank and holding company capital adequacy guidelines are shown in the accompanying table, as are the capital ratios of the Company and the Bank, as of March 31, 2014, and December 31, 2013. These ratios are consistent with the ratios disclosed in the most recent filings with the regulatory agencies.

At March 31, 2014, the Company, on a consolidated basis, exceeded the minimum thresholds for adequately capitalized organizations under regulatory definitions. The Company and the Bank are subject to regulatory capital requirements administered by federal banking agencies.

Capital levels and industry defined regulatory minimum required levels:

|  | Actual     |        | Minimum Required<br>for Capital<br>Adequacy Purposes |       | Minimum Required<br>to be Well<br>Capitalized <sup>1</sup> |       |
|--|------------|--------|--|-------|--|-------|
|  | Amount     | Ratio  | Amount   | Ratio | Amount   | Ratio |
| <b>March 31, 2014</b>                  |            |        |  |       |  |       |
| Total capital to risk weighted assets  |            |        |  |       |  |       |
| Consolidated                           | \$ 207,702 | 15.87% | \$ 104,702   | 8.00% | N/A  | N/A   |
| Old Second Bank                        | 232,590    | 17.83  | 104,359  | 8.00  | 130,449  | 10.00 |
| Tier 1 capital to risk weighted assets |            |        |  |       |  |       |
| Consolidated                           | 141,943    | 10.85  | 52,329   | 4.00  | N/A  | N/A   |
| Old Second Bank                        | 216,180    | 16.58  | 52,154   | 4.00  | 78,232   | 6.00  |
| Tier 1 capital to average assets       |            |        |  |       |  |       |
| Consolidated                           | 141,943    | 7.29   | 77,884   | 4.00  | N/A  | N/A   |
| Old Second Bank                        | 216,180    | 11.12  | 77,763   | 4.00  | 97,203   | 5.00  |
| <b>December 31, 2013</b>               |            |        |  |       |  |       |
| Total capital to risk weighted assets  |            |        |  |       |  |       |
| Consolidated                           | \$ 200,139 | 15.88% | \$ 100,826   | 8.00% | N/A  | N/A   |
| Old Second Bank                        | 227,467    | 18.04  | 100,872  | 8.00  | 126,090  | 10.00 |
| Tier 1 capital to risk weighted assets |            |        |  |       |  |       |
| Consolidated                           | 134,199    | 10.65  | 50,403   | 4.00  | N/A  | N/A   |
| Old Second Bank                        | 211,568    | 16.78  | 50,433   | 4.00  | 75,650   | 6.00  |
| Tier 1 capital to average assets       |            |        |  |       |  |       |
| Consolidated                           | 134,199    | 6.96   | 77,126   | 4.00  | N/A  | N/A   |
| Old Second Bank                        | 211,568    | 10.97  | 77,144   | 4.00  | 96,430   | 5.00  |

<sup>1</sup> The Bank exceeded the general minimum regulatory requirements to be considered well capitalized.

The Company's credit facility with Bank of America includes \$45.0 million in subordinated debt. That debt obligation continues to qualify as Tier 2 regulatory capital. In addition, the trust preferred securities continue to qualify as Tier 1 regulatory capital, and the Company treats the maximum amount of this security type allowable under regulatory guidelines as Tier 1 capital. As of March 31, 2014, trust preferred proceeds of \$52.3 million qualified as Tier 1 regulatory capital and \$4.3 million qualified as Tier 2 regulatory capital. As of December 31, 2013, trust preferred proceeds of \$51.6 million qualified as

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Tier 1 regulatory capital and \$5.0 million qualified as Tier 2 regulatory capital. All of the Series B Stock qualified as Tier 1 regulatory capital as of March 31, 2014, and December 31, 2013. See Note 17 for a discussion of Series B Stock repurchased by the Company on April 28, 2014.

**Dividend Restrictions and Deferrals**

In addition to the above requirements, banking regulations and capital guidelines generally limit the amount of dividends that may be paid by a Bank without prior regulatory approval. Under these regulations, the amount of dividends that may be paid in any calendar year is limited to the current year's profits, combined with the retained profit of the previous two years, subject to the capital requirements described above.

As discussed in Note 8, as of March 31, 2014, the Company had \$58.4 million of junior subordinated debentures held by two statutory business trusts that it controls. The Company has the right to defer interest payments on the debentures for a period of up to 20 consecutive quarters, and elected to begin such a deferral in August 2010. However, all deferred interest must be paid before the Company may pay dividends on its capital stock. Therefore, the Company will not be able to pay dividends on its common stock until all deferred interest on these debentures has been paid in full. The total amount of such deferred and unpaid interest as of March 31, 2014, was \$18.4 million.

On April 21, 2014, the Company paid the accumulated unpaid interest and terminated the deferral period. In order to terminate the deferral period, the Company paid all accumulated and unpaid interest on the trust preferred securities through the next payment date set forth in the indentures, which totaled \$19.7 million. The interest will not be immediately paid by the indenture trustees to the securities holders. Instead, the indenture trustees will hold interest payments in irrevocable deposit accounts. The interest will be paid by the trustees on the next applicable payment dates in June, 2014 under the indentures to the holders of the securities on the record dates set forth in the appropriate indentures.

Furthermore, as with the debentures discussed above, the Company is prohibited from paying dividends on its common stock unless it has fully paid all accrued dividends on the Series B Stock. In August 2010, it also began to defer the payment of dividends on such Series B Stock. Therefore, in addition to paying all the accrued and unpaid distributions on the debentures set forth above, the Company must also fully pay all deferred and unpaid dividends on the Series B Stock before it may reinstate the payment of dividends on the common stock. The total amount of deferred and unpaid Series B Stock dividends as of March 31, 2014, was \$14.8 million.

On April 15, 2014, the Company declared a dividend of approximately \$15.8 million on its Series B Stock to stockholders of record on May 1, 2014, with the dividend to be paid on May 15, 2014.

On April 28, 2014, the Company repurchased 25,669 shares of the Series B Stock from certain holders, which included certain of the Company's directors, at a repurchase price of 94.75% of the per share liquidation value, or \$947.50 per share, for a total price of approximately \$24.3 million. The Company paid \$22.9 million to a large private investor and an additional \$1.4 million to Company directors for these purchases. The holders of such shares waived their rights to any dividends on the Series B Stock, and such holders will not receive any part of the declared dividend on the Series B Stock.

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Further detail on the subordinated debentures, the Series B Stock and the deferral of interest and dividends thereon is described in Notes 8, 15 and 17.

### **Note 12 Fair Value Option and Fair Value Measurements**

Fair value is defined as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. The fair value hierarchy established by

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the Company also requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. Three levels of inputs that may be used to measure fair value are:

Level 1: Quoted prices (unadjusted) for identical assets or liabilities in active markets that the Company has the ability to access as of the measurement date.

Level 2: Significant observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities, quoted prices in markets that are not active, and other inputs that are observable or can be corroborated by observable market data.

Level 3: Significant unobservable inputs that reflect a company's own view about the assumptions that market participants would use in pricing an asset or liability.

Transfers between levels are deemed to have occurred at the end of the reporting period. For the quarters ended March 31, 2014 and 2013 there were no significant transfers between levels.

Except for auction rate asset-backed securities, the majority of securities (available-for-sale and held-to-maturity) are valued by external pricing services or dealer market participants and are classified in Level 2 of the fair value hierarchy. Both market and income valuation approaches are utilized. Quarterly, the Company evaluates the methodologies used by the external pricing services or dealer market participants to develop the fair values to determine whether the results of the valuations are representative of an exit price in the Company's principal markets and an appropriate representation of fair value. The Company uses the following methods and significant assumptions to estimate fair value:

- Government-sponsored agency debt securities are primarily priced using available market information through processes such as benchmark curves, market valuations of like securities, sector groupings and matrix pricing.
- Other government-sponsored agency securities, MBS, real estate mortgage investment conduits, collateralized mortgage obligations and non-auction rate asset-backed securities are priced using available market information including benchmark yields, prepayment speeds, spreads, volatility of similar securities and trade date.
- State and political subdivisions are largely grouped by characteristics (e.g., geographical data and source of revenue in trade dissemination systems). Because some securities are not traded daily and due to other grouping limitations, active market quotes are often obtained using benchmarking for like securities.
- During 2013, asset-backed auction rate securities were acquired and priced using data from dealer market participants until December 31, 2013. At December 31, 2013 to present and including asset-backed auction rate securities acquired in 2014, the Company utilized pricing data from a nationally recognized valuation firm providing specialized securities valuation services. Therefore, the valuation of auction rate asset-backed securities are considered Level 3 valuations.
- Residential mortgage loans eligible for sale in the secondary market are carried at fair market value. The fair value of loans held-for-sale is determined using quoted secondary market prices.



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- Lending related commitments to fund certain residential mortgage loans, e.g. residential mortgage loans with locked interest rates to be sold in the secondary market and forward commitments for the future delivery of mortgage loans to third party investors as well as forward commitments for future delivery of MBS are considered derivatives. Fair values are estimated based on observable changes in mortgage interest rates including prices for MBS from the date of the commitment and do not typically involve significant judgments by management.
- The fair value of mortgage servicing rights is based on a valuation model that calculates the present value of estimated net servicing income. The valuation model incorporates assumptions that market participants would use in estimating future net servicing income to derive the resultant value. The Company is able to compare the valuation model inputs, such as the discount

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rate, prepayment speeds, weighted average delinquency and foreclosure/bankruptcy rates to widely available published industry data for reasonableness.

- Interest rate swap positions, both assets and liabilities, are based on valuation pricing models using an income approach reflecting readily observable market parameters such as interest rate yield curves.
- Both the credit valuation reserve on current interest rate swap positions and on receivables related to unwound customer interest rate swap positions were determined based upon management's estimate of the amount of credit risk exposure, including by available collateral protection and/or by utilizing an estimate related to a probability of default as indicated in the Bank credit policy. Such adjustments would result in a Level 3 classification.
- The fair value of impaired loans with specific allocations of the allowance for loan losses is essentially based on recent real estate appraisals. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are made in the appraisal process by the appraisers to reflect differences between the available comparable sales and income data. Such adjustments are usually significant and typically result in a Level 3 classification of the inputs for determining fair value.
- Nonrecurring adjustments to certain commercial and residential real estate properties classified as OREO are measured at the lower of carrying amount or fair value, less costs to sell. Fair values are based on third party appraisals of the property, resulting in a Level 3 classification. In cases where the carrying amount exceeds the fair value, less costs to sell, an impairment loss is recognized.

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**Assets and Liabilities Measured at Fair Value on a Recurring Basis:**

The tables below present the balance of assets and liabilities at March 31, 2014, and December 31, 2013, respectively, as measured by the Company at fair value on a recurring basis:

|   | March 31, 2014  |                   |                   |                   |
|---|-----------------|-------------------|-------------------|-------------------|
|   | Level 1         | Level 2           | Level 3           | Total             |
| <b>Assets:</b>  |                 |                   |                   |                   |
| Investment securities available-for-sale                                  |                 |                   |                   |                   |
| U.S. Treasury   | \$ 1,540        | \$ -              | \$ -              | \$ 1,540          |
| U.S. government agencies  | -               | 1,665             | -                 | 1,665             |
| States and political subdivisions   | -               | 26,334            | 125               | 26,459            |
| Corporate bonds   | -               | 31,272            | -                 | 31,272            |
| Collateralized mortgage obligations                                       | -               | 51,124            | -                 | 51,124            |
| Asset-backed securities   | -               | 129,814           | 158,338           | 288,152           |
| Loans held-for-sale   | -               | 2,507             | -                 | 2,507             |
| Mortgage servicing rights   | -               | -                 | 5,614             | 5,614             |
| Other assets (Interest rate swap agreements net of swap credit valuation) | -               | 125               | (1)               | 124               |
| Other assets (Mortgage banking derivatives)                               | -               | 320               | -                 | 320               |
| <b>Total</b>  | <b>\$ 1,540</b> | <b>\$ 243,161</b> | <b>\$ 164,076</b> | <b>\$ 408,777</b> |
| <b>Liabilities:</b>   |                 |                   |                   |                   |
| Other liabilities (Interest rate swap agreements)                         | \$ -            | \$ 125            | \$ -              | \$ 125            |
| <b>Total</b>  | <b>\$ -</b>     | <b>\$ 125</b>     | <b>\$ -</b>       | <b>\$ 125</b>     |

|   | December 31, 2013 |                   |                   |                   |
|---|-------------------|-------------------|-------------------|-------------------|
|   | Level 1           | Level 2           | Level 3           | Total             |
| <b>Assets:</b>  |                   |                   |                   |                   |
| Investment securities available-for-sale                                  |                   |                   |                   |                   |
| U.S. Treasury   | \$ 1,544          | \$ -              | \$ -              | \$ 1,544          |
| U.S. government agencies  | -                 | 1,672             | -                 | 1,672             |
| States and political subdivisions   | -                 | 16,669            | 125               | 16,794            |
| Corporate bonds   | -                 | 15,102            | -                 | 15,102            |
| Collateralized mortgage obligations                                       | -                 | 63,876            | -                 | 63,876            |
| Asset-backed securities   | -                 | 119,066           | 154,137           | 273,203           |
| Loans held-for-sale   | -                 | 3,822             | -                 | 3,822             |
| Mortgage servicing rights   | -                 | -                 | 5,807             | 5,807             |
| Other assets (Interest rate swap agreements net of swap credit valuation) | -                 | 229               | (6)               | 223               |
| Other assets (Mortgage banking derivatives)                               | -                 | 315               | -                 | 315               |
| <b>Total</b>  | <b>\$ 1,544</b>   | <b>\$ 220,751</b> | <b>\$ 160,063</b> | <b>\$ 382,358</b> |
| <b>Liabilities:</b>   |                   |                   |                   |                   |
| Other liabilities (Interest rate swap agreements)                         | \$ -              | \$ 229            | \$ -              | \$ 229            |
| <b>Total</b>  | <b>\$ -</b>       | <b>\$ 229</b>     | <b>\$ -</b>       | <b>\$ 229</b>     |



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The changes in Level 3 assets and liabilities measured at fair value on a recurring basis using significant unobservable inputs are summarized as follows:

|   | Three months ended March 31, 2014 |                                   |                           |                              |  |
|---|-----------------------------------|-----------------------------------|---------------------------|------------------------------|--|
|   | Securities available-for-sale     |                                   |                           |                              |  |
|   | Asset-Backed                      | States and Political Subdivisions | Mortgage Servicing Rights | Interest Rate Swap Valuation |  |
| Beginning balance January 1, 2014               | \$ 154,137                        | \$ 125                            | \$ 5,807                  | \$ (6)                       |  |
| Transfers into Level 3                          | -                                 | -                                 | -                         | -                            |  |
| Total gains or losses                           |                                   |                                   |                           |                              |  |
| Included in earnings (or changes in net assets) | 226                               | -                                 | 111                       | 5                            |  |
| Included in other comprehensive income          | (315)                             | -                                 | -                         | -                            |  |
| Purchases, issuances, sales, and settlements    |                                   |                                   |                           |                              |  |
| Purchases                                       | 4,290                             | -                                 | -                         | -                            |  |
| Issuances                                       | -                                 | -                                 | (304)                     | -                            |  |
| Ending balance March 31, 2014                   | \$ 158,338                        | \$ 125                            | \$ 5,614                  | \$ (1)                       |  |

  

|   | Three months ended March 31, 2013 |              |                                   |                           |                              |
|---|-----------------------------------|--------------|-----------------------------------|---------------------------|------------------------------|
|   | Securities available-for-sale     |              |                                   |                           |                              |
|   | Collateralized Debt Obligations   | Asset-Backed | States and Political Subdivisions | Mortgage Servicing Rights | Interest Rate Swap Valuation |
| Beginning balance January 1, 2013               | \$ 9,957                          | \$ -         | \$ 132                            | \$ 4,116                  | \$ (47)                      |
| Transfers into Level 3                          | -                                 | 106,028      | -                                 | -                         | -                            |
| Transfers out of Level 3                        | -                                 | -            | -                                 | -                         | -                            |
| Total gains or losses                           |                                   |              |                                   |                           |                              |
| Included in earnings (or changes in net assets) | 42                                | -            | -                                 | (106)                     | 14                           |
| Included in other comprehensive income          | 692                               | -            | -                                 | -                         | -                            |
| Purchases, issuances, sales, and settlements    |                                   |              |                                   |                           |                              |
| Issuances                                       | -                                 | -            | -                                 | 459                       | -                            |
| Settlements                                     | (64)                              | -            | -                                 | -                         | -                            |
| Ending balance March 31, 2013                   | \$ 10,627                         | \$ 106,028   | \$ 132                            | \$ 4,469                  | \$ (33)                      |

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The following table and commentary presents quantitative (dollars in thousands) and qualitative information about Level 3 fair value measurements as of March 31, 2014:

| <b>Measured at fair value on a recurring basis:</b> | Fair Value | Valuation Methodology                                   | Unobservable Inputs                       | Range of Input          | Weighted Average of Inputs |
|---|------------|---|---|-------------------------|----------------------------|
| Mortgage Servicing rights                           | 5,614      | Discounted Cash Flow                                    | Discount Rate<br>Prepayment Speed         | 9.8-12.0%<br>3.7-36.34% | 10.2%<br>10.3%             |
| Interest Rate Swap Valuation                        | (1)        | Management estimate of credit risk exposure             | Probability of Default                    | 5.0-20.0%               | 12.6%                      |
| Asset-backed securities                             | 158,338    | Discounted Cash Flow with comparable transaction yields | Credit Risk Premium<br>Liquidity Discount | 0.9%-1.2%<br>4.1-4.7%   | 1.1%<br>4.5%               |

The following table and commentary presents quantitative (dollars in thousands) and qualitative information about Level 3 fair value measurements as of December 31, 2013:

| <b>Measured at fair value on a recurring basis:</b> | Fair Value | Valuation Methodology                                   | Unobservable Inputs                       | Range of Input       | Weighted Average of Inputs |
|---|------------|---|---|----------------------|----------------------------|
| Mortgage Servicing rights                           | \$ 5,807   | Discounted Cash Flow                                    | Discount Rate<br>Prepayment Speed         | 10.2%<br>9.7%        | 10.2%<br>9.7%              |
| Interest Rate Swap Valuation                        | (6)        | Management estimate of credit risk exposure             | Probability of Default                    | 5.0-20.0%            | 12.5%                      |
| Asset-backed securities                             | 154,137    | Discounted Cash Flow with comparable transaction yields | Credit Risk Premium<br>Liquidity Discount | 1.1-1.5%<br>4.5-5.1% | 1.2%<br>4.9%               |

The \$125,000 on the States and political subdivisions line at March 31, 2014, represents a security from a small, local municipality. This is categorized as a Level 3 security based on the payment stream received by the Company from the municipality. That payment stream is otherwise an unobservable input.

**Assets and Liabilities Measured at Fair Value on a Nonrecurring Basis:**

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The Company may be required, from time to time, to measure certain other assets at fair value on a nonrecurring basis in accordance with GAAP. These assets consist of impaired loans and OREO. For assets measured at fair value on a nonrecurring basis on hand at March 31, 2014, and December 31, 2013, respectively, the following tables provide the level of valuation assumptions used to determine each valuation and the carrying value of the related assets:

|   | March 31, 2014 |             |                  |                  |  |
|---|----------------|-------------|------------------|------------------|--|
|   | Level 1        | Level 2     | Level 3          | Total            |  |
| Impaired loans <sup>1</sup>               | \$ -           | \$ -        | \$ 3,375         | \$ 3,375         |  |
| Other real estate owned, net <sup>2</sup> | -              | -           | 40,220           | 40,220           |  |
| <b>Total</b>                              | <b>\$ -</b>    | <b>\$ -</b> | <b>\$ 43,595</b> | <b>\$ 43,595</b> |  |

<sup>1</sup> Represents carrying value and related write-downs of loans for which adjustments are substantially based on the appraised value of collateral for collateral-dependent loans, had a carrying amount of \$4.6

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million, with a valuation allowance of \$1.2 million, resulting in a decrease of specific allocations within the provision for loan losses of \$1.1 million for the quarter ending March 31, 2014. The carrying value of loans fully charged off is zero.

2 OREO is measured at the lower of carrying or fair value less costs to sell, had a net carrying amount of \$40.2 million, which is made up of the outstanding balance of \$61.5 million, net of a valuation allowance of \$19.5 million and participations of \$1.8 million, at March 31, 2014, resulting in a charge to expense of \$436,000 for the quarter ended March 31, 2014.

|   | December 31, 2013 |         |           | Total     |
|---|-------------------|---------|-----------|-----------|
|   | Level 1           | Level 2 | Level 3   |           |
| Impaired loans <sup>1</sup>               | \$ -              | \$ -    | \$ 9,103  | \$ 9,103  |
| Other real estate owned, net <sup>2</sup> | -                 | -       | 41,537    | 41,537    |
| Total                                     | \$ -              | \$ -    | \$ 50,640 | \$ 50,640 |

1 Represents carrying value and related write-downs of loans for which adjustments are substantially based on the appraised value of collateral for collateral-dependent loans, had a carrying amount of \$11.5 million, with a valuation allowance of \$2.4 million, resulting in a decrease of specific allocations within the provision for loan losses of \$3.9 million for the year ending December 31, 2013. The carrying value of loans fully charged-off is zero.

2 OREO is measured at the lower of carrying or fair value less costs to sell, had a net carrying amount of \$41.5 million, which is made up of the outstanding balance of \$65.9 million, net of a valuation allowance of \$22.3 million and participations of \$2.1 million, at December 31, 2013, resulting in a charge to expense of \$8.3 million for the year ended December 31, 2013.

The Company also has assets that under certain conditions are subject to measurement at fair value on a nonrecurring basis. These assets include OREO and impaired loans. The Company has estimated the fair values of these assets based primarily on Level 3 inputs. OREO and impaired loans are generally valued using the fair value of collateral provided by third party appraisals. These valuations include assumptions related to cash flow projections, discount rates, and recent comparable sales. The numerical range of unobservable inputs for these valuation assumptions are not meaningful.

**Note 13 Financial Instruments with Off-Balance Sheet Risk and Derivative Transactions**

To meet the financing needs of its customers, the Bank, as a subsidiary of the Company, is a party to various financial instruments with off balance sheet risk in the normal course of business. These off balance sheet financial instruments include commitments to originate and sell loans as well as financial standby, performance standby and commercial letters of credit. The instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the consolidated balance sheet. The Bank's credit exposure for loan



commitments and letters of credit is represented by the dollar amount of those instruments. Management generally uses the same credit policies and collateral requirements in making commitments and conditional obligations as it does for on balance sheet instruments.

### **Interest Rate Swaps**

The Company also has interest rate derivative positions to assist with risk management not designated as hedging instruments. These derivative positions relate to transactions in which the Bank enters into an interest rate swap agreement with a client while at the same time entering into an offsetting

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interest rate swap with another financial institution. Due to financial covenant violations relating to nonperforming loans, the Bank had \$3.1 million in investment securities pledged to support interest rate swap activity with three correspondent financial institutions at March 31, 2014 and December 31, 2013. In connection with each transaction, the Bank agreed to pay interest to the client on a notional amount at a variable interest rate and receive interest from the client on the same notional amount at a fixed interest rate.

At the same time, the Bank agreed to pay another financial institution the same fixed interest rate on the same notional amount and receive the same variable interest rate on the same notional amount. The transaction allows the client to convert a variable rate loan to a fixed rate loan and is part of the Company's interest rate risk management strategy. Because the Bank acts as an intermediary for the client, changes in the fair value of the underlying derivative contracts offset each other and do not generally affect the results of operations. Fair value measurements include an assessment of credit risk related to the client's ability to perform on their contract position, however, and valuation estimates related to that exposure are discussed in Note 12 above. At March 31, 2014, the notional amount of non-hedging interest rate swaps was \$41.7 million with a weighted average maturity of 1.5 years. At December 31, 2013, the notional amount of non-hedging interest rate swaps was \$51.9 million with a weighted average maturity of 1.5 years. The Bank offsets derivative assets and liabilities that are subject to a master netting arrangement.

The Bank also grants mortgage loan interest rate lock commitments to borrowers, subject to normal loan underwriting standards. The interest rate risk associated with these loan interest rate lock commitments is managed with contracts for future deliveries of loans as well as selling forward mortgage-backed securities contracts. Loan interest rate lock commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. Commitments to originate residential mortgage loans held-for-sale and forward commitments to sell residential mortgage loans or forward mortgage-backed securities contracts are considered derivative instruments and changes in the fair value are recorded to mortgage banking revenue. Fair values are estimated based on observable changes in mortgage interest rates including mortgage-backed securities prices from the date of the commitment.

The following table presents derivatives not designated as hedging instruments as of March 31, 2014, and periodic changes in the values of the interest rate swaps are reported in other noninterest income. Periodic changes in the value of the forward contracts related to mortgage loan origination are reported in the net gain on sales of mortgage loans.

|  | Notional or Contractual Amount | Asset Derivatives      |            | Liability Derivatives  |            |
|--|--------------------------------|------------------------|------------|------------------------|------------|
|  |                                | Balance Sheet Location | Fair Value | Balance Sheet Location | Fair Value |
| Interest rate swap contracts net of credit valuation | \$ 41,707                      | Other Assets           | \$ 124     | Other Liabilities      | \$ 125     |
| Commitments <sup>1</sup>                             | 218,172                        | Other Assets           | 320        | N/A                    | -          |
| Forward contracts <sup>2</sup>                       | 13,000                         | N/A                    | -          | Other Liabilities      | -          |
| Total  |                                |                        | \$ 444     |                        | \$ 125     |

<sup>1</sup>Includes unused loan commitments and interest rate lock commitments.

<sup>2</sup>Includes forward MBS contracts and forward loan contracts.



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The following table presents derivatives not designated as hedging instruments as of December 31, 2013.

|  | Notional or Contractual Amount | Asset Derivatives      |            | Liability Derivatives  |            |
|--|--------------------------------|------------------------|------------|------------------------|------------|
|  |                                | Balance Sheet Location | Fair Value | Balance Sheet Location | Fair Value |
| Interest rate swap contracts net of credit valuation | \$ 51,877                      | Other Assets           | \$ 223     | Other Liabilities      | \$ 229     |
| Commitments <sup>1</sup>                             | 206,965                        | Other Assets           | 315        | N/A                    | -          |
| Forward contracts <sup>2</sup>                       | 11,500                         | N/A                    | -          | Other Liabilities      | -          |
| Total  |                                |                        | \$ 538     |                        | \$ 229     |

<sup>1</sup>Includes unused loan commitments and interest rate lock commitments.

<sup>2</sup>Includes forward MBS contracts.

The Bank also issues letters of credit, which are conditional commitments that guarantee the performance of a customer to a third party. The credit risk involved and collateral obtained in issuing letters of credit are essentially the same as that involved in extending loan commitments to our customers.

In addition to customer related commitments, the Company is responsible for letters of credit commitments that relate to properties held in OREO. The following table represents the Company's contractual commitments due to letters of credit as of March 31, 2014, and December 31, 2013.

The following table is a summary of financial instrument commitments (in thousands):

|                     | March 31, 2014 |          |          | December 31, 2013 |          |          |
|---------------------|----------------|----------|----------|-------------------|----------|----------|
|                     | Fixed          | Variable | Total    | Fixed             | Variable | Total    |
| Letters of credit:  |                |          |          |                   |          |          |
| Borrower:           |                |          |          |                   |          |          |
| Financial standby   | \$ 5           | \$ 4,314 | \$ 4,319 | \$ 10             | \$ 3,886 | \$ 3,896 |
| Commercial standby  | -              | 49       | 49       | -                 | 51       | 51       |
| Performance standby | 416            | 6,058    | 6,474    | 1,580             | 2,723    | 4,303    |
|                     | 421            | 10,421   | 10,842   | 1,590             | 6,660    | 8,250    |
| Nonborrower:        |                |          |          |                   |          |          |
| Performance standby | -              | 622      | 622      | -                 | 867      | 867      |
|                     | -              | 622      | 622      | -                 | 867      | 867      |

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|                         |    |     |    |        |    |        |    |       |    |       |    |       |
|-------------------------|----|-----|----|--------|----|--------|----|-------|----|-------|----|-------|
| Total letters of credit | \$ | 421 | \$ | 11,043 | \$ | 11,464 | \$ | 1,590 | \$ | 7,527 | \$ | 9,117 |
|-------------------------|----|-----|----|--------|----|--------|----|-------|----|-------|----|-------|

**Note 14 Fair Values of Financial Instruments**

The estimated fair values of financial instruments approximate carrying amount for all items except those described in the following table. Investment security fair values are based upon market prices or dealer quotes, and if no such information is available, on the rate and term of the security. The carrying value of FHLBC stock approximates fair value as the stock is nonmarketable and can only be sold to the FHLBC or another member institution at par. During the years ended December 31, 2013, and 2012, the Company participated in multiple redemptions with the FHLBC and using the redemption

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values as the carrying value, FHLBC stock was transferred to a Level 2 fair value as of December 31, 2012. The Company had no redemptions in the first quarter of 2014. Fair values of loans were estimated for portfolios of loans with similar financial characteristics, such as type and fixed or variable interest rate terms. Cash flows were discounted using current rates at which similar loans would be made to borrowers with similar ratings and for similar maturities. The fair value of time deposits is estimated using discounted future cash flows at current rates offered for deposits of similar remaining maturities. The fair values of borrowings were estimated based on interest rates available to the Company for debt with similar terms and remaining maturities. The fair value of off balance sheet volume is not considered material.

The carrying amount and estimated fair values of financial instruments were as follows:

|  | Carrying<br>Amount | Fair<br>Value | March 31, 2014 |           |           |
|--|--------------------|---------------|----------------|-----------|-----------|
|  |                    |               | Level 1        | Level 2   | Level 3   |
| <b>Financial assets:</b>                                 |                    |               |                |           |           |
| Cash and due from banks                                  | \$ 40,245          | \$ 40,245     | \$ 40,245      | \$ -      | \$ -      |
| Interest bearing deposits with<br>financial institutions | 14,242             | 14,242        | 14,242         | -         | -         |
| Securities available-for-sale                            | 400,212            | 400,212       | 1,540          | 240,209   | 158,463   |
| Securities held-to-maturity                              | 264,298            | 264,250       | -              | 264,250   | -         |
| FHLBC and FRB Stock                                      | 10,292             | 10,292        | -              | 10,292    | -         |
| Bank-owned life insurance                                | 55,768             | 55,768        | -              | 55,768    | -         |
| Loans held for sale                                      | 2,507              | 2,507         | -              | 2,507     | -         |
| Loans, net   | 1,085,761          | 1,085,205     | -              | -         | 1,085,205 |
| Accrued interest receivable                              | 4,536              | 4,536         | -              | 4,536     | -         |
| <b>Financial liabilities:</b>                            |                    |               |                |           |           |
| Noninterest bearing deposits                             | \$ 387,090         | \$ 387,090    | \$ 387,090     | \$ -      | \$ -      |
| Interest bearing deposits                                | 1,337,191          | 1,338,614     | -              | 1,338,614 | -         |
| Securities sold under repurchase<br>agreements           | 23,212             | 23,212        | -              | 23,212    | -         |
| Other short-term borrowings                              | 20,000             | 20,000        | -              | 20,000    | -         |
| Junior subordinated debentures                           | 58,378             | 70,185        | 41,635         | 28,550    | -         |
| Subordinated debenture                                   | 45,000             | 40,512        | -              | 40,512    | -         |
| Note payable and other borrowings                        | 500                | 431           | -              | 431       | -         |
| Borrowing interest payable                               | 18,425             | 18,425        | 10,955         | 7,470     | -         |
| Deposit interest payable                                 | 698                | 698           | -              | 698       | -         |

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|  | December 31, 2013  |               |            |           |           |
|--|--------------------|---------------|------------|-----------|-----------|
|  | Carrying<br>Amount | Fair<br>Value | Level 1    | Level 2   | Level 3   |
| <b>Financial assets:</b>                                 |                    |               |            |           |           |
| Cash and due from banks                                  | \$ 33,210          | \$ 33,210     | \$ 33,210  | \$ -      | \$ -      |
| Interest bearing deposits with<br>financial institutions | 14,450             | 14,450        | 14,450     | -         | -         |
| Securities available-for-sale                            | 372,191            | 372,191       | 1,544      | 216,385   | 154,262   |
| Securities held-to-maturity                              | 256,571            | 254,328       |            | 254,328   |           |
| FHLBC and FRB Stock                                      | 10,292             | 10,292        | -          | 10,292    | -         |
| Bank-owned life insurance                                | 55,410             | 55,410        | -          | 55,410    | -         |
| Loans held for sale                                      | 3,822              | 3,822         | -          | 3,822     | -         |
| Loans, net   | 1,073,975          | 1,072,837     | -          | -         | 1,072,837 |
| Accrued interest receivable                              | 4,248              | 4,248         | -          | 4,248     | -         |
| <b>Financial liabilities:</b>                            |                    |               |            |           |           |
| Noninterest bearing deposits                             | \$ 373,389         | \$ 373,389    | \$ 373,389 | \$ -      | \$ -      |
| Interest bearing deposits                                | 1,308,739          | 1,312,476     | -          | 1,312,476 | -         |
| Securities sold under repurchase<br>agreements           | 22,560             | 22,560        | -          | 22,560    | -         |
| Other short-term borrowings                              | 5,000              | 5,000         | -          | 5,000     | -         |
| Junior subordinated debentures                           | 58,378             | 67,053        | 39,777     | 27,276    | -         |
| Subordinated debenture                                   | 45,000             | 39,896        | -          | 39,896    | -         |
| Note payable and other borrowings                        | 500                | 423           | -          | 423       | -         |
| Borrowing interest payable                               | 17,037             | 17,037        | 10,122     | 6,915     | -         |
| Deposit interest payable                                 | 762                | 762           | -          | 762       | -         |

**Note 15 Preferred Stock**

The Company's Series B Stock was issued to Treasury as part of the Treasury's Troubled Asset Relief Program and Capital Purchase Program (the CPP). The Series B Stock qualifies as Tier 1 capital and pays cumulative dividends on the liquidation preference amount on a quarterly basis at a rate of 5% per annum for the first five years, and 9% per annum thereafter effective in February 2014. Concurrent with issuing the Series B Stock, the Company issued to the Treasury a ten year warrant to purchase 815,339 shares of the Company's common stock at an exercise price of \$13.43 per share.

Subsequent to the Company's receipt of the \$73.0 million in proceeds from the Treasury in the first quarter of 2009, the Company allocated the proceeds between the Series B Stock and warrants that were issued. The Company recorded the warrant as equity, and the allocation was based on their relative fair values in accordance with accounting guidance. The fair value was determined for both the Series B Stock and the warrant as part of the allocation process in the amounts of \$68.2 million and \$4.8 million, respectively.

As discussed in Note 11, on August 31, 2010, the Company announced that it would begin deferring quarterly cash dividends on its outstanding Series B Stock. Further, as discussed in Note 8 and Note 11, the Company also elected to defer interest payments on certain of its subordinated debentures. However, under the terms of the Series B Stock, if the Company fails to pay dividends for an aggregate of six quarters on the Series B Stock, whether or not consecutive, the holders have the right to appoint representatives to the Company's board of directors. As the Company elected to defer dividends for more than six quarters, a new director was appointed by the Treasury to join the board during the fourth quarter of 2012. The terms of the Series B Stock also prevent the Company from paying cash dividends or generally repurchasing its common stock while Series B Stock dividends are in arrears. The total amount of unpaid and deferred Series B Stock dividends as of March 31, 2014, was \$14.8 million.

The Treasury sold all of the Series B Stock held to third parties, including certain of our directors, in auctions that were completed in the first quarter of 2013. The Treasury also sold the warrant to a third



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party at a subsequent auction. Upon completion by Treasury of the auction, the Company's board affirmed the director appointed by Treasury to ongoing board membership, and the Series B director was elected by the holders of the Series B Stock at the Company's 2013 annual meeting. At March 31, 2014, the Company carried \$73.0 million of Series B Stock in total stockholders' equity. At December 31, 2013, the Company carried \$72.9 million of Series B Stock in total stockholders' equity.

As a result of the completed auctions, the Company's Board elected to stop accruing the dividend on the Series B Stock in the first quarter 2013. Previously, the Company had accrued the dividend on the Series B Stock quarterly throughout the deferral period. Given the discount reflected in the results of the auction, the board believed that the Company would be able to repurchase the Series B Stock in the future at a price less than the face amount of the Series B Stock and the accrued and unpaid dividends. Therefore, the Company did not fully accrue the dividend on the Series B Stock in the first quarter and did not accrue for it in subsequent quarters. The Company has continued to evaluate whether accruing dividends on the remaining Series B Stock is appropriate. The Company currently intends to declare and pay future dividends on these shares.

On April 28, 2014, the Company repurchased Series B Stock at an agreed upon price reached in private negotiations. Payments of \$24.3 million resulted in repurchase of 25,669 shares of Series B Stock. See Note 17 for additional information.

**Note 16 Income Taxes**

Income tax expense for year to date March 31, 2014 and March 31, 2013 was as follows:

|                               | March 31, 2014 | March 31, 2013 |
|-------------------------------|----------------|----------------|
| Current federal               | \$ 23          | \$ -           |
| Current state                 | 7              | -              |
| Deferred federal              | 889            | 1,500          |
| Deferred state                | 279            | 328            |
| Change in valuation allowance | -              | (1,828)        |
|                               | \$ 1,198       | \$ -           |

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The following were the components of the deferred tax assets and liabilities as of March 31, 2014 and December 31, 2013:

|  | March 31, 2014 |    | December 31, 2013 |
|--|----------------|----|-------------------|
| Allowance for loan losses                          | \$ 11,527      | \$ | 12,725            |
| Deferred compensation                              | 792            |    | 788               |
| Amortization of core deposit intangible assets     | 1,822          |    | 1,656             |
| Goodwill amortization/impairment                   | 14,859         |    | 15,252            |
| Stock option expense                               | 589            |    | 583               |
| OREO write downs                                   | 9,062          |    | 10,041            |
| Federal net operating loss ( NOL ) carryforward    | 29,272         |    | 28,023            |
| State net operating loss ( NOL ) carryforward      | 12,146         |    | 11,847            |
| Deferred tax credit                                | 1,444          |    | 1,444             |
| Other assets                                       | 560            |    | 1,166             |
| Total deferred tax assets                          | 82,073         |    | 83,525            |
| Accumulated depreciation on premises and equipment | (938)          |    | (1,035)           |
| Accretion on securities                            | (8)            |    | (8)               |
| Mortgage servicing rights                          | (2,485)        |    | (2,571)           |
| State tax benefits                                 | (6,896)        |    | (6,994)           |
| Other liabilities                                  | (175)          |    | (178)             |
| Total deferred tax liabilities                     | (10,502)       |    | (10,786)          |
| Net deferred tax asset before valuation allowance  | 71,571         |    | 72,739            |
| Tax effect on net unrealized losses on securities  | 5,245          |    | 4,927             |
| Valuation allowance                                | (2,363)        |    | (2,363)           |
| Net deferred tax asset                             | \$ 74,453      | \$ | 75,303            |

At March 31, 2014, the Company had \$83.6 million federal net operating loss carryforward of which, \$25.3 million expires in 2030, \$31.4 million expires in 2031, \$8.6 million expires in 2032, \$14.7 million expires in 2033, and \$3.6 million expires in 2034. The Company had \$127.9 million state net operating loss carryforward of which, \$29.4 million expires in 2021, \$95.3 million expires in 2025, and \$3.2 million expires in 2026. In addition, the Company had a \$1.4 million alternative minimum tax credit subject to indefinite carryforward.

The components of the provision for deferred income tax expense were as follows:

|  | March 31, 2014 |    | March 31, 2013 |
|--|----------------|----|----------------|
| Allowance for loan losses                      | \$ 1,198       | \$ | 823            |
| Deferred Compensation                          | (4)            |    | (13)           |
| Amortization of core deposit intangible assets | (166)          |    | (172)          |
| Stock option expense                           | (6)            |    | 226            |
| OREO write downs                               | 979            |    | 2,873          |
| Federal net operating loss carryforward        | (1,249)        |    | (1,829)        |
| State net operating loss carryforward          | (299)          |    | (551)          |
| Depreciation                                   | (97)           |    | 14             |
| Net premiums and discounts on securities       | -              |    | 20             |
| Mortgage servicing rights                      | (86)           |    | 156            |
| Goodwill amortization/impairment               | 393            |    | 392            |
| State tax benefits                             | (98)           |    | (115)          |
| Change in valuation allowance                  | -              |    | (1,828)        |
| Other, net                                     | 603            |    | 4              |

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|                            |    |       |    |   |
|----------------------------|----|-------|----|---|
| Total deferred tax expense | \$ | 1,168 | \$ | - |
|----------------------------|----|-------|----|---|

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Effective tax rates differ from federal statutory rates applied to financial statement loss due to the following:

|  | March 31, 2014 |    | March 31, 2013 |
|--|----------------|----|----------------|
| Tax at statutory federal income tax rate                         | \$ 1,190       | \$ | 1,915          |
| Nontaxable interest income, net of disallowed interest deduction | (67)           |    | (51)           |
| BOLI income  | (125)          |    | (143)          |
| State income taxes, net of federal benefit                       | 186            |    | 291            |
| General business credit  | -              |    | (15)           |
| Change in valuation allowance                                    | -              |    | (1,828)        |
| Deficiency from restricted stock                                 | -              |    | 76             |
| Other, net   | 14             |    | (245)          |
| Tax at effective tax rate  | \$ 1,198       | \$ | -              |

**Note 17 Subsequent Events**

In April 2014, the Company received net proceeds of over \$64.0 million from a public offering of 15,525,000 shares of its common stock. As previously disclosed, the Company used the proceeds in part to pay approximately \$19.7 million in accrued but unpaid interest on its subordinated debentures and has approved \$15.8 million to pay the accumulated but unpaid dividend on the Series B Stock. The Company also used approximately \$24.3 million of the proceeds to repurchase 25,669 shares of its Series B Stock from certain holders, which included certain of the Company's directors. The remaining proceeds will be used for general corporate purposes. As a result of the repurchase of the Series B Stock, the Company will record an income statement benefit. This benefit will be reflected in the Company's second quarter consolidated statements of operations.

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**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

**Overview**

The Company is a financial services company with its main headquarters located in Aurora, Illinois. The Company is the holding company of Old Second National Bank (the "Bank"), a national banking organization headquartered in Aurora, Illinois and provides commercial and retail banking services, as well as a full complement of trust and wealth management services. The Company has offices located in Cook, Kane, Kendall, DeKalb, DuPage, LaSalle and Will counties in Illinois. The following management's discussion and analysis is presented to provide information concerning our financial condition as of March 31, 2014, as compared to December 31, 2013, and the results of operations for the three months ended March 31, 2014, and 2013. This discussion and analysis is most comprehensively read in conjunction with our consolidated financial statements as well as the financial and statistical data appearing elsewhere in this report and our 2013 Form 10-K.

In the markets where the Company primarily operates, economies continued to recover in an uneven fashion. The economies in these markets continued to show gradual improvement in the first quarter of 2014 as did the national financial infrastructure. Real estate markets in the Company's market areas are well short of robust and continue to pressure borrower financial strength. This has resulted in still elevated, but improved and improving levels of nonperforming loans and other real estate owned. Management remains vigilant in analyzing loan portfolio quality and making decisions to charge-off loans. To that end, the Company recognized improved asset quality by recording a \$1.0 million loan loss reserve release in the quarter with net income of \$2.2 million prior to Series B Stock dividends in the period. This compared to a \$2.5 million loan loss reserve release and a net income of \$5.5 million prior to Series B Stock dividends for the same period in 2013. The \$1.0 million loan loss reserve release for the period was appropriate in light of ongoing improvements in loan portfolio quality.

Net income of \$3.4 million (before taxes) in the first quarter of 2014 compares to \$5.5 million for the first quarter of 2013. In addition to the larger loan loss reserve release in first quarter 2013, last year's quarter included stronger net interest income and significantly stronger residential mortgage banking revenue as well as \$1.5 million in securities gains compared to nominal securities losses in the 2014 first quarter.

In April, 2014 the Company concluded a successful capital raise issuing 15,525,000 common shares with net proceeds in excess of \$64.0 million. To date proceeds have been used to pay \$19.7 million accrued but previously unpaid interest on trust preferred securities and to repurchase certain shares of Series B Stock. On April 28, 2014 the Company repurchased Series B Stock at an agreed upon price reached in private negotiations. Payments of \$22.9 million were made to a large private investor with other payments totaling \$1.4 million made to directors of the Company. See Note 17 for additional information. In May, 2014 the Company will apply proceeds to pay the accumulated but unpaid dividends on Series B Stock. Any remaining proceeds will be used for general corporate purposes including payment for various services required during the offering.

**Results of Operations**

Earnings per share for the first quarter of 2014 was \$.04 per diluted share on \$2.2 million of net income. This compares to \$.30 per diluted share, on net income of \$5.5 million for the first quarter of 2013. The net income available to common stockholders was \$630,000 for the first quarter of 2014 after preferred stock dividends and accretion of \$1.6 million. The first quarter 2014 preferred stock dividend incorporates an increase in the dividend rate from 5% to 9% in February 2014. First quarter 2013 net income available to common stockholders was \$4.2

million for the first quarter of 2013 after Series B Stock dividends and accretion of \$1.3 million.

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**Net Interest Income**

Net interest and dividend income decreased \$307,000, from \$13.9 million for the quarter ended March 31, 2013, to \$13.6 million for the quarter ended March 31, 2014. Average earning assets decreased \$6.6 million, or 0.4%, from a total of \$1.78 billion in the first quarter of 2013. Management continued to emphasize asset quality. New loan originations while improved continued to be limited, business leader confidence remained moderate and the competitive landscape was intense in our markets. Average loans, including loans held for sale, decreased \$37.3 million from the first quarter of 2013 to the first quarter of 2014. On a linked quarter basis, average loan volume, including loans held for sale, increased \$31.2 million reversing a 2013 trend of declining volume of this metric.

Management continues to develop loan pipelines and expects that pipeline volume will generate future loan growth. As loan volume continues measured but slow paced growth, management increased total securities in the first quarter of 2014 to 32.3% of total assets up from 31.4% at the end of 2013 to utilize available liquid funds.

The net interest margin (tax-equivalent basis), expressed as a percentage of average earning assets, decreased from 3.18% in the first quarter of 2013 to 3.13% in the first quarter of 2014. The average tax-equivalent yield on earning assets decreased from 3.94% in the first quarter of 2013 to 3.79% in the first quarter of 2014. For the same comparative period, the cost of funds on interest bearing liabilities decreased from 0.95% to 0.86% providing some offset to the decrease in earning asset yield.

The growth of lower yielding securities (average balance up again in the first quarter period on a linked quarter basis continuing a 2013 trend of increasing volume of this metric) and reductions in higher yielding loans were the main causes of decreased net interest income. Period loan yields are reflective of competitive pressures on new loan yield. Additionally, management continued to see pressure to reduce interest rates on loans retained at renewal and found it necessary to accept rate concessions to keep the business.

Management, in order to evaluate and measure performance, uses certain non-GAAP performance measures and ratios. This includes tax-equivalent net interest income (including its individual components) and net interest margin (including its individual components) to total average interest earning assets. Management believes that these measures and ratios provide users of the financial information with a more accurate view of the performance of the interest earning assets and interest bearing liabilities and of the Company's operating efficiency for comparison purposes. Other financial holding companies may define or calculate these measures and ratios differently. See the tables and notes below for supplemental data and the corresponding reconciliations to GAAP financial measures for the three-month periods ended March 31, 2014, and 2013.

The following tables set forth certain information relating to the Company's average consolidated balance sheets and reflect the yield on average earning assets and cost of average liabilities for the periods indicated. Dividing the related interest by the average balance of assets or liabilities derives the disclosed rates. Average balances are derived from daily balances. For purposes of discussion, net interest income and net interest income to total earning assets on the following tables have been adjusted to a non-GAAP tax equivalent (TE) basis using a marginal rate of 35% to more appropriately compare returns on tax-exempt loans and securities to other earning assets.

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ANALYSIS OF AVERAGE BALANCES,  
TAX EQUIVALENT INTEREST AND RATES

Three Months ended March 31, 2014, and 2013

(Dollar amounts in thousands - unaudited)

|  | 2014               |           |       | 2013               |           |       |
|--|--------------------|-----------|-------|--------------------|-----------|-------|
|  | Average<br>Balance | Interest  | Rate  | Average<br>Balance | Interest  | Rate  |
| <b>Assets</b>  |                    |           |       |                    |           |       |
| Interest bearing deposits  | \$ 23,775          | \$ 15     | 0.25% | \$ 68,995          | \$ 42     | 0.24% |
| Securities:  |                    |           |       |                    |           |       |
| Taxable  | 616,433            | 3,502     | 2.27  | 548,231            | 2,298     | 1.68  |
| Non-taxable (tax equivalent)                                       | 18,561             | 228       | 4.91  | 10,002             | 183       | 7.32  |
| Total securities   | 634,994            | 3,730     | 2.35  | 558,233            | 2,481     | 1.78  |
| Dividends from FRB and FHLB<br>stock                               | 10,292             | 76        | 2.95  | 11,202             | 76        | 2.71  |
| Loans and loans held-for-sale 1                                    | 1,106,409          | 12,988    | 4.70  | 1,143,666          | 14,971    | 5.24  |
| Total interest earning assets                                      | 1,775,470          | 16,809    | 3.79  | 1,782,096          | 17,570    | 3.94  |
| Cash and due from banks  | 29,901             | -         | -     | 29,913             | -         | -     |
| Allowance for loan losses  | (27,102)           | -         | -     | (38,994)           | -         | -     |
| Other noninterest bearing assets                                   | 236,356            | -         | -     | 203,417            | -         | -     |
| Total assets   | \$ 2,014,625       |           |       | \$ 1,976,432       |           |       |
| <b>Liabilities and Stockholders<br/>Equity</b>                     |                    |           |       |                    |           |       |
| NOW accounts   | \$ 303,553         | \$ 64     | 0.09% | \$ 291,051         | \$ 64     | 0.09% |
| Money market accounts  | 314,803            | 94        | 0.12  | 329,377            | 123       | 0.15  |
| Savings accounts   | 234,353            | 41        | 0.07  | 221,889            | 41        | 0.07  |
| Time deposits  | 468,138            | 1,321     | 1.14  | 505,685            | 1,853     | 1.49  |
| Interest bearing deposits  | 1,320,847          | 1,520     | 0.47  | 1,348,002          | 2,081     | 0.63  |
| Securities sold under repurchase<br>agreements                     | 24,539             | 1         | 0.02  | 20,264             | 1         | 0.02  |
| Other short-term borrowings  | 4,111              | 1         | 0.10  | 43,833             | 19        | 0.17  |
| Junior subordinated debentures                                     | 58,378             | 1,387     | 9.50  | 58,378             | 1,287     | 8.82  |
| Subordinated debt  | 45,000             | 196       | 1.74  | 45,000             | 196       | 1.74  |
| Notes payable and other<br>borrowings                              | 500                | 4         | 3.20  | 500                | 4         | 3.20  |
| Total interest bearing liabilities                                 | 1,453,375          | 3,109     | 0.86  | 1,515,977          | 3,588     | 0.95  |
| Noninterest bearing deposits                                       | 373,711            | -         | -     | 353,476            | -         | -     |
| Other liabilities  | 38,966             | -         | -     | 33,585             | -         | -     |
| Stockholders equity  | 148,573            | -         | -     | 73,394             | -         | -     |
| Total liabilities and<br>stockholders equity                       | \$ 2,014,625       |           |       | \$ 1,976,432       |           |       |
| Net interest income (tax<br>equivalent)                            |                    | \$ 13,700 |       |                    | \$ 13,982 |       |
| Net interest income (tax<br>equivalent) to total earning<br>assets |                    |           | 3.13% |                    |           | 3.18% |
| Interest bearing liabilities to<br>earning assets                  | 81.86%             |           |       | 85.07%             |           |       |



1. Interest income from loans is shown on a TE basis as discussed below and includes fees of \$550,000 and \$671,000 for the first quarter of 2014 and 2013, respectively. Nonaccrual loans are included in the above-stated average balances.

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As indicated previously, the Company adjusts net interest income and net interest income to earning assets to a non-GAAP TE basis using a marginal rate of 35% to more appropriately compare returns on TE loans and securities to other earning assets. The table below provides a reconciliation of each non-GAAP TE measure to the GAAP equivalent for the periods indicated:

|   | Effect of Tax Equivalent Adjustment |              |
|---|-------------------------------------|--------------|
|   | Three Months Ended<br>March 31,     |              |
|   | 2014                                | 2013         |
| Interest income (GAAP)                                    | \$ 16,704                           | \$ 17,490    |
| Taxable equivalent adjustment - loans                     | 25                                  | 16           |
| Taxable equivalent adjustment - securities                | 80                                  | 64           |
| Interest income (TE)                                      | 16,809                              | 17,570       |
| Less: interest expense (GAAP)                             | 3,109                               | 3,588        |
| Net interest income (TE)                                  | \$ 13,700                           | \$ 13,982    |
| Net interest and income (GAAP)                            | \$ 13,595                           | \$ 13,902    |
| Average interest earning assets                           | \$ 1,775,470                        | \$ 1,782,096 |
| Net interest income to total interest earning assets      | 3.11%                               | 3.16%        |
| Net interest income to total interest earning assets (TE) | 3.13%                               | 3.18%        |

**Provision for Loan Losses / Loan Loss Reserve Release**

The Company's \$1.0 million loan loss reserve release in the first quarter of 2014 compares to a \$2.5 million reserve release in the first quarter of 2013. The provision for loan loss creates a reserve for probable and estimable losses inherent in the loan portfolio. Reserve releases reflect management's measured decision that probable and estimable losses have been reduced. On a quarterly basis, management estimates the amount required and records the appropriate provision or release to maintain an adequate reserve for these potential and estimated loan losses. The \$1.0 million loan loss reserve release in the first quarter of 2014 continues a 2013 trend of quarterly reserve releases. In each quarter of 2013, management concluded that quarterly releases were justified with quarterly amounts ranging from \$1.8 million to \$2.5 million.

Nonperforming loans decreased to \$38.6 million at March 31, 2014 from \$39.8 million at December 31, 2013. Net charge-offs totaled \$805,000 in first quarter 2014 while net recoveries totaled \$2.5 million for the first quarter of 2013. The distribution of the Company's remaining nonperforming loans are included in the following table.

| (in thousands) | Nonperforming Loans as of |                   | March 31, 2014 |                                      | March 31, 2013 |
|----------------|---------------------------|-------------------|----------------|--------------------------------------|----------------|
|                | March 31, 2014            | December 31, 2013 | March 31, 2013 | Dollar change From December 31, 2013 |                |
|                |                           |                   |                |                                      |                |



Nonperforming loans consist of nonaccrual loans, nonperforming restructured accruing loans and loans 90 days or greater past due. The only increase of significance in nonperforming loans since

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December 31, 2013 was in the real estate commercial, nonfarm segment as migration of loans to nonaccrual were in excess of upgrades and migration to OREO. Remediation work continues in all segments. Importantly, new migration to nonaccrual continues to be minimal.

| Loan Charge-offs, net of recoveries<br>(in thousands) | Three Months Ended |                      |                   |
|---|--------------------|----------------------|-------------------|
|   | March 31,<br>2014  | December 31,<br>2013 | March 31,<br>2013 |
| Real estate-construction                              |                    |                      |                   |
| Homebuilder   | \$ (35)            | \$ -                 | \$ 3              |
| Land  | 1                  | (1)                  | (1)               |
| Commercial speculative                                | -                  | 62                   | (767)             |
| All other   | 65                 | 1                    | (1)               |
| Total real estate-construction                        | 31                 | 62                   | (766)             |
| Real estate-residential                               |                    |                      |                   |
| Investor  | 92                 | 547                  | (149)             |
| Owner occupied  | 8                  | (15)                 | (19)              |
| Revolving and junior liens                            | 499                | 139                  | 349               |
| Total real estate-residential                         | 599                | 671                  | 181               |
| Real estate-commercial, nonfarm                       |                    |                      |                   |
| Owner general purpose                                 | -                  | -                    | (19)              |
| Owner special purpose                                 | 259                | (3)                  | 117               |
| Non-owner general purpose                             | 18                 | (1,258)              | (317)             |
| Non-owner special purpose                             | -                  | -                    | (824)             |
| Retail properties                                     | (89)               | 296                  | (1,173)           |
| Total real estate-commercial, nonfarm                 | 188                | (965)                | (2,216)           |
| Real estate-commercial, farm                          | -                  | -                    | -                 |
| Commercial  | (11)               | (7)                  | 235               |
| Other   | (2)                | 5                    | 29                |
|   | \$ 805             | \$ (234)             | \$ (2,537)        |

Charge-offs for the first quarter 2014 were, in many instances, from previously established specific reserves on nonaccrual loans deemed uncollectible. Gross charge-offs for the first quarter of 2014 were \$1.4 million compared to \$1.5 million for the first quarter of 2013 and \$1.9 million for the fourth quarter of 2013 reflecting our efforts to improve loan quality in better but still challenging markets. Recoveries were \$555,000, \$4.1 million and \$2.1 million for the same time periods, respectively.

| (in thousands)                  | Classified loans as of |                      |                   | March 31, 2013<br>Dollar Change From |                   |
|---------------------------------|------------------------|----------------------|-------------------|--------------------------------------|-------------------|
|                                 | March 31,<br>2014      | December 31,<br>2013 | March 31,<br>2013 | December 31,<br>2013                 | March 31,<br>2013 |
| Real estate-construction        | \$ 6,430               | \$ 3,024             | \$ 12,656         | \$ 3,406                             | \$ (6,226)        |
| Real estate-residential:        |                        |                      |                   |                                      |                   |
| Investor                        | 7,674                  | 9,750                | 8,913             | (2,076)                              | (1,239)           |
| Owner occupied                  | 6,847                  | 7,699                | 10,463            | (852)                                | (3,616)           |
| Revolving and junior liens      | 3,645                  | 3,971                | 5,722             | (326)                                | (2,077)           |
| Real estate-commercial, nonfarm | 27,633                 | 37,297               | 61,442            | (9,664)                              | (33,809)          |
| Real estate-commercial, farm    | -                      | -                    | 2,417             | -                                    | (2,417)           |
| Commercial                      | 455                    | 481                  | 747               | (26)                                 | (292)             |
| Other                           | -                      | 1                    | 1                 | (1)                                  | (1)               |
|                                 | \$ 52,684              | \$ 62,223            | \$ 102,361        | \$ (9,539)                           | \$ (49,677)       |

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Classified loans include nonaccrual, performing troubled debt restructurings and all other loans considered substandard. Loans classified as substandard are inadequately protected by the current net worth and paying capacity of the obligor, or by the collateral pledged to secure the loan, if any. These loans have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt and carry the distinct possibility that the Company will sustain some loss if deficiencies remain uncorrected.

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Classified assets include both classified loans and OREO. Management monitors a ratio of classified assets to the sum of Bank Tier 1 capital and the allowance for loan and lease loss reserve as another measure of overall change in loan related asset quality. With the decline in both classified loans and OREO in the first quarter, this ratio improved to 38.44% at March 31, 2014, down from 43.44% at December 31, 2013.

Allowance for Loan and Lease Losses

Below is a reconciliation of the activity for loan losses for the periods indicated (in thousands):

|  | March 31,<br>2014 | Three Months Ending<br>December 31,<br>2013 | March 31,<br>2013 |
|--|-------------------|---|-------------------|
| Allowance at beginning of quarter                      | \$ 27,281         | \$ 29,547                                   | \$ 38,597         |
| Charge-offs:   |                   |   |                   |
| Commercial   | 4                 | 8   | 254               |
| Real estate - commercial                               | 329               | 608   | 508               |
| Real estate - construction                             | 68                | 63  | 4                 |
| Real estate - residential                              | 849               | 1,100                                       | 585               |
| Consumer and other loans                               | 110               | 123   | 172               |
| Total charge-offs                                      | 1,360             | 1,902                                       | 1,523             |
| Recoveries:  |                   |   |                   |
| Commercial   | 15                | 15  | 19                |
| Real estate - commercial                               | 141               | 1,573                                       | 2,724             |
| Real estate - construction                             | 37                | 1   | 770               |
| Real estate - residential                              | 250               | 429   | 404               |
| Consumer and other loans                               | 112               | 118   | 143               |
| Total recoveries                                       | 555               | 2,136                                       | 4,060             |
| Net charge-offs (recoveries)                           | 805               | (234)                                       | (2,537)           |
| Loan loss reserve release                              | (1,000)           | (2,500)                                     | (2,500)           |
| Allowance at end of period                             | \$ 25,476         | \$ 27,281                                   | \$ 38,634         |
| <br>   |                   |   |                   |
| Average total loans (exclusive of loans held-for-sale) | \$ 1,104,065      | \$ 1,072,320                                | \$ 1,138,579      |
| Net charge-offs to average loans                       | 0.07%             | -0.02%                                      | -0.22%            |
| Allowance at period end to average loans               | 2.31%             | 2.54%                                       | 3.39%             |
| <br>   |                   |   |                   |
| Ending balance: Individually evaluated for impairment  | \$ 1,247          | \$ 2,395                                    | \$ 5,038          |
| Ending balance: Collectively evaluated for impairment  | \$ 24,229         | \$ 24,886                                   | \$ 33,596         |

The coverage ratio of the allowance for loan losses to nonperforming loans was 66.0% as of March 31, 2014, which reflects a slight decrease from 68.6% as of December 31, 2013. Management updated the estimated specific allocations in the first quarter after receiving more recent appraisals for detailed collateral valuations or information on cash flow trends related to the impaired credits. This update resulted in a lower amount required in the reserve for estimable losses on these credits at the end of the first quarter 2014 compared to year end 2013. The estimated general allocation was essentially unchanged from December 31, 2013, as the overall credit condition of our loan portfolio adjusted for environmental factors remained relatively stable during the quarter. The third component of the Company's loan loss reserve analysis showed lower required reserves, most notably in the pooled commercial real estate category. Management determined that the dollar amount of loans in this component was markedly lower at period end first quarter 2014 compared to year end 2013. In summary, after careful and detailed review, management determined an appropriate amount to release from the allowance for loan losses. Factors considered include loan growth or contraction, the quality and composition of the loan portfolio and loan loss experience.

The above changes in estimates were made by management to be consistent with observable trends within loan portfolio segments and in conjunction with market conditions and credit review administration activities. Management also reviewed and evaluated several environmental factors. These

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factors are evaluated on an ongoing basis and are included in the assessment of the adequacy of the allowance for loan losses.

After a review of the adequacy of the loan loss reserve at March 31, 2014, management concluded that a \$1.0 million reserve release was justified. When measured as a percentage of loans outstanding, the total allowance for loan losses decreased slightly from 2.5% of total loans as of December 31, 2013 to 2.3% of total loans at March 31, 2014. In management's judgment, an adequate, measured and entirely appropriate allowance for estimated losses has been established for inherent losses at March 31, 2014; however, there can be no assurance that actual losses will not exceed the estimated amounts in the future.

**Other Real Estate Owned**

OREO decreased modestly by \$1.3 million from \$41.5 million at December 31, 2013, to \$40.2 million at March 31, 2014. Disposition activity and valuation writedowns in the first quarter exceeded additions to OREO as shown below. As a result, holdings in lots suitable for development and commercial property decreased in the quarter. The dollar value of vacant land was unchanged at end of the first quarter. Overall, a net gain on sale of \$386,000 was realized in the first quarter. Lower total OREO (down from \$65.7 million at March 31, 2013) has resulted in reduced expenses to carry and operate remaining properties.

| (in thousands)               | March 31,<br>2014 | Three Months Ended<br>December 31,<br>2013 | March 31,<br>2013 |
|------------------------------|-------------------|--|-------------------|
| Beginning balance            | \$ 41,537         | \$ 49,066                                  | \$ 72,423         |
| Property additions           | 4,688             | 4,998                                      | 6,985             |
| Development improvements     | -                 | 13   | 50                |
| Less:                        |                   |  |                   |
| Property disposals           | 5,569             | 10,784                                     | 11,661            |
| Period valuation adjustments | 436               | 1,756                                      | 2,134             |
| Other real estate owned      | \$ 40,220         | \$ 41,537                                  | \$ 65,663         |

The OREO valuation reserve decreased to \$19.5 million, which is 32.6% of gross OREO at March 31, 2014. The valuation reserve represented 32.1% and 34.9% of gross OREO at March 31, 2013, and December 31, 2013, respectively. In management's judgment, the property valuation allowance as established presents OREO at current estimates of fair value less costs to sell; however, there can be no assurance that additional losses will not be incurred on disposition or update to valuation in the future. Of note, one commercial property of five lots valued in total at \$1.0 million has been in OREO for over five years.

**OREO Properties by Type**

| (in thousands)                      | March 31, 2014 |            | December 31, 2013 |            | March 31, 2013 |            |
|-------------------------------------|----------------|------------|-------------------|------------|----------------|------------|
|                                     | Amount         | % of Total | Amount            | % of Total | Amount         | % of Total |
| Single family residence             | \$ 4,730       | 12%        | \$ 4,658          | 11%        | \$ 9,854       | 15%        |
| Lots (single family and commercial) | 14,298         | 36%        | 15,020            | 36%        | 26,130         | 40%        |



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|                       |           |      |           |      |           |      |
|-----------------------|-----------|------|-----------|------|-----------|------|
| Vacant land           | 3,135     | 8%   | 3,135     | 8%   | 4,610     | 7%   |
| Multi-family          | 5,045     | 12%  | 1,783     | 4%   | 2,134     | 3%   |
| Commercial property   | 13,012    | 32%  | 16,941    | 41%  | 22,935    | 35%  |
| Total OREO properties | \$ 40,220 | 100% | \$ 41,537 | 100% | \$ 65,663 | 100% |

Table of Contents**Noninterest Income**

| (in thousands)  | Three Months Ended |                 | March 31, 2014<br>Dollar Change From |                 |                   |
|---|--------------------|-----------------|--------------------------------------|-----------------|-------------------|
|   | 1sr Qtr<br>2014    | 4th Qtr<br>2013 | 1sr Qtr<br>2013                      | 4th Qtr<br>2013 | 1sr Qtr<br>2013   |
| Trust income  | \$ 1,459           | \$ 1,673        | \$ 1,491                             | \$ (214)        | \$ (32)           |
| Service charges on deposits                                   | 1,720              | 1,877           | 1,677                                | (157)           | 43                |
| Residential mortgage banking revenue                          | 727                | 1,858           | 2,450                                | (1,131)         | (1,723)           |
| Securities (loss) gains, net                                  | (69)               | 14              | 1,453                                | (83)            | (1,522)           |
| Loss on sale of CDO   | -                  | (4,117)         | -                                    | 4,117           | -                 |
| Total securities (loss) gains, net                            | (69)               | (4,103)         | 1,453                                | 4,034           | (1,522)           |
| Increase in cash surrender value of bank-owned life insurance | 358                | 405             | 407                                  | (47)            | (49)              |
| Debit card interchange income                                 | 830                | 893             | 792                                  | (63)            | 38                |
| Other income  | 1,296              | 1,263           | 1,737                                | 33              | (441)             |
| <b>Total noninterest income</b>                               | <b>\$ 6,321</b>    | <b>\$ 3,866</b> | <b>\$ 10,007</b>                     | <b>\$ 2,455</b> | <b>\$ (3,686)</b> |

Excluding the fourth quarter 2013 \$4.1 million loss on CDO sales, noninterest income decreased in first quarter 2014 on a linked quarter basis. The Company sold the CDO following the December 2013 announcements of the implementation of Section 619 of the *Dodd Frank Wall Street Reform and Consumer Protection Act*, commonly referred to as the Volcker Rule. Reviewing core operational noninterest revenue, on a linked quarter basis residential mortgage banking revenue decreased sharply reflecting industry headwinds on this service offering. Further, industry reports indicate that the mortgage refinance market in the Chicago area is strained by underwater ownership positions. Approximately 31% of Chicago area homeowners with a mortgage owed at least 25% more on the home than the property's current value. Another 16% were between 10% negative equity and 10% positive equity. First quarter 2014 mortgage servicing income net of changes in fair value dropped sharply from both fourth quarter and first quarter 2013. Other categories of Company noninterest income were essentially flat or down.

Similar results are found comparing first quarter 2014 to first quarter 2013 with the additional consideration that the Company recorded a small 2014 loss on non-core noninterest revenue for securities sales compared to a \$1.5 million gain on securities sales in first quarter 2013. The 2013 period also included a large gain on the recapture of restricted stock from senior executives as required by the regulations governing the Troubled Assets Relief Program.

The Company's residential mortgage banking revenue reflects trends extensively reported in local and national business reports. For example, recent national reports indicate that mortgage originations fell to a 14 year low in first quarter. The \$235 billion in mortgage loans made in the first quarter of 2014 was 23% lower than in the fourth quarter of 2013 and down 58% from a year ago. Locally, management sees sharply lower application volume year over year as the refinance business reflects some market saturation with fewer customers needing to or qualifying for refinance. Management also sees increases in the purchase pipeline, but at a slower pace with some communities in our markets continuing to be difficult.

Table of Contents**Noninterest Expense**

| (in thousands)                                 | Three Months Ended |                      | March 31, 2014<br>Dollar Change From |                      |                   |
|--|--------------------|----------------------|--------------------------------------|----------------------|-------------------|
|  | March 31,<br>2014  | December 31,<br>2013 | March 31,<br>2013                    | December 31,<br>2013 | March 31,<br>2013 |
| Salaries                                       | \$ 6,872           | \$ 7,141             | \$ 6,715                             | \$ (269)             | \$ 157            |
| Bonus  | 709                | 686                  | 659                                  | 23                   | 50                |
| Benefits and others                            | 1,520              | 1,353                | 1,658                                | 167                  | (138)             |
| Total salaries and employee benefits           | 9,101              | 9,180                | 9,032                                | (79)                 | 69                |
| Occupancy expense, net                         | 1,481              | 1,245                | 1,279                                | 236                  | 202               |
| Furniture and equipment expense                | 983                | 990                  | 1,144                                | (7)                  | (161)             |
| FDIC insurance                                 | 279                | 981                  | 1,035                                | (702)                | (756)             |
| General bank insurance                         | 489                | 489                  | 849                                  | -                    | (360)             |
| Amortization of core deposit intangible assets | 512                | 525                  | 525                                  | (13)                 | (13)              |
| Advertising expense                            | 303                | 384                  | 166                                  | (81)                 | 137               |
| Debit card interchange expense                 | 378                | 361                  | 344                                  | 17                   | 34                |
| Legal fees                                     | 257                | 642                  | 323                                  | (385)                | (66)              |
| Other real estate owned expense, net           | 1,008              | 1,804                | 3,097                                | (796)                | (2,089)           |
| Other expense                                  | 2,725              | 3,472                | 3,144                                | (747)                | (419)             |
| <b>Total noninterest expense</b>               | <b>\$ 17,516</b>   | <b>\$ 20,073</b>     | <b>\$ 20,938</b>                     | <b>\$ (2,557)</b>    | <b>\$ (3,422)</b> |

All categories of noninterest expense were essentially flat or down in the first quarter from the prior quarter, except for weather related occupancy expense. Expense reflecting payments of the Bank FDIC assessment is down sharply in part due to the lifting of the Company's written agreement with the Reserve Bank and the termination of the consent order with the OCC. Legal expense dropped on fewer problem loan or OREO issues requiring legal counsel and also after appropriately comprehensive expense accrual in fourth quarter 2013. OREO expense reflects reduced valuation expenses as market values have improved. On a linked quarter basis, OREO valuation expense dropped sharply. The linked quarter decrease in valuation expense was the third consecutive quarterly decrease on this metric. All other noninterest expense is down quarter to quarter on appropriate and significant accruals in fourth quarter 2013.

Year over year all categories of noninterest expense are flat to down except occupancy as discussed above and advertising expense for programs in 2014 related to consumer products. All OREO expense information in this filing incorporates a Company decision at year end 2013 to reclassify OREO revenue to noninterest expense.

**Income Taxes**

The Company recorded a tax expense of \$1.2 million on \$3.4 million pre-tax income for the first quarter of 2014. The tax expense was composed of \$30,000 in current income tax expense and \$1.2 million in deferred income tax expense.

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On September 12, 2012, the Company and the Bank, as rights agent, entered into the Amended and Restated Rights Agreement and Tax Benefits Preservation Plan (the Tax Benefits Plan ). The Tax Benefits Plan amended and restated the Rights Agreement, dated September 17, 2002. The purpose of the Tax Benefits Plan is to protect the Company's deferred tax asset against an unsolicited ownership change, which could significantly limit the Company's ability to utilize its deferred tax assets. The Tax Benefits Plan was ratified by the Company's stockholders at the Company's 2013 annual meeting. In connection with the public offering, the Company amended the Tax Benefits Plan on April 3, 2014, to allow two investors to purchase more than 5% of the Company's common stock.

The determination of being able to realize the deferred tax assets is highly subjective and dependent upon judgment concerning management's evaluation of both positive and negative evidence, including forecasts of future income, available tax planning strategies, and assessments of the current and

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future economic and business conditions. Management considered both positive and negative evidence regarding the Company's ability to ultimately realize the deferred tax assets, which is largely dependent upon the ability to derive benefits based upon future taxable income. As of September 30, 2013, management determined that the realization of most of the deferred tax asset was more likely than not as required by accounting principles and reversed a significant portion of an established valuation allowance to reflect this judgment. The remaining valuation allowance is for a portion of the state net operating loss carryforward the Company could possibly use, but does not meet the threshold of more likely than not at March 31, 2014.

The Company considered the federal and state net operating loss carryforwards separately when determining if a valuation allowance was required. After considering tax-planning strategies, the Company reserved a portion of the state net operating loss carryforward management did not anticipate using by December 31, 2016 based on forecasts made at September 30, 2013. While the state net operating loss carryforward does not begin to expire until 2021, management acknowledges that forecasts are inherently subjective and only periods in the foreseeable future should be considered when determining if net deferred tax assets will be utilized. In each future accounting period, the Company's management will reevaluate whether the current conditions in conjunction with positive and negative evidence support a change in the valuation allowance against the Company's deferred tax assets. Any such subsequent reduction in the estimated valuation allowance would lower the amount of income tax expense recognized in the Company's consolidated statements of operations in future periods.

The positive evidence considered included the following: (1) the current quarter results reflect the Company's sixth consecutive quarter of pre-tax earnings (2) reduced nonperforming assets for the eleventh consecutive quarter (3) strongly encouraging indications from OCC on the removal of the Consent Order subsequently confirmed with the removal of the Consent Order effective October 17, 2013. Negative evidence considered included the decrease in the Company's net interest margin and reduced noninterest income, primarily from decreased mortgage banking revenue. The only tax planning strategy considered was selling the Company's bank-owned life insurance which would have produced immediate taxable income of approximately \$12.0 million if it had been sold effective March 31, 2014 (up from \$11.4 million projected if sale had been consummated effective September 30, 2013). While the Company does not anticipate completing this sale, management would consider the sale in the event a deferred tax asset was close to expiration.

**Financial Condition**

Total assets increased \$55.4 million, or 2.8%, from December 31, 2013, to \$2.06 billion as of March 31, 2014. Loans increased by \$10.0 million, or 0.9%, as management continued to emphasize credit quality under an overarching relationship lending program. At the same time, loan charge-off activity reduced balances and collateral that previously secured loans moved to OREO. OREO decreased \$1.3 million, or 3.2% at March 31, 2014, compared to year end 2013. Available-for-sale securities increased by \$28.0 million for the period while one purchase combined with portfolio paydowns in the quarter resulted in a net \$7.7 million increase in held-to-maturity securities in the three months ended March 31, 2014.

The core deposit intangible asset related to the Heritage Bank acquisition in February 2008 decreased from \$1.2 million at December 31, 2013, to \$665,000 as of March 31, 2014. Management performed an annual review of the core deposit intangible assets as of November 30, 2013. Based upon that review and ongoing quarterly monitoring, management determined there was no impairment of the core deposit intangible assets as of March 31, 2014. No assurance can be given that future impairment tests will not result in a charge to earnings.

**Loans**



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Total loans were \$1.11 billion as of March 31, 2014, an increase of \$10.0 million from \$1.10 billion as of December 31, 2013. The increase in loans reflects successful loan production work in the quarter after extensive work in previous periods to build a robust loan pipeline. An overriding effort to develop relationship based loan clients also resulted in current loan clients more closely reflecting our core clientele. Our existing commercial clients have not been utilizing existing lines of credit as we would expect in a healthier economy. Challenging economic headwinds and an intensely competitive environment served to temper overall loan growth.

| (in thousands)              | Major Classification of Loans as of |                      |                   | March 31, 2014<br>Dollar Change From |                   |
|-----------------------------|-------------------------------------|----------------------|-------------------|--------------------------------------|-------------------|
|                             | March 31,<br>2014                   | December 31,<br>2013 | March 31,<br>2013 | December 31,<br>2013                 | March 31,<br>2012 |
| Commercial                  | \$ 98,321                           | \$ 94,736            | \$ 84,332         | \$ 3,585                             | \$ 13,989         |
| Real estate - commercial    | 579,297                             | 560,233              | 566,349           | 19,064                               | 12,948            |
| Real estate - construction  | 32,016                              | 29,351               | 40,698            | 2,665                                | (8,682)           |
| Real estate - residential   | 375,781                             | 390,201              | 394,599           | (14,420)                             | (18,818)          |
| Consumer                    | 2,837                               | 2,760                | 2,908             | 77                                   | (71)              |
| Overdraft                   | 301                                 | 628                  | 584               | (327)                                | (283)             |
| Lease financing receivables | 9,227                               | 10,069               | 8,574             | (842)                                | 653               |
| Other                       | 13,019                              | 12,793               | 15,022            | 226                                  | (2,003)           |
|                             | 1,110,799                           | 1,100,771            | 1,113,066         | 10,028                               | (2,267)           |
| Net deferred loan costs     | 438                                 | 485                  | 236               | (47)                                 | 202               |
|                             | \$ 1,111,237                        | \$ 1,101,256         | \$ 1,113,302      | \$ 9,981                             | \$ (2,065)        |

The quality of the loan portfolio incorporates not only Company credit decisions but also the economic health of the communities in which the Company operates. The local economies are still subject to the continued sluggish economic conditions that have been experienced nationwide. The adverse economic conditions continue to affect the midwest region in particular and financial markets generally, and real estate related activity, including valuations and transactions, continues to be in distress. As the Company is located in a corridor with significant open space and undeveloped real estate, real estate lending (including commercial, residential, and construction) has been and continues to be a sizeable portion of the portfolio. These categories comprised 88.8% of the portfolio as of March 31, 2014, compared to 89.0% of the portfolio as of December 31, 2013. The Company continues to oversee and manage its loan portfolio in accordance with interagency guidance on risk management.

Consistent with that commitment and management's response to the now terminated Consent Order with the OCC, management updated its asset diversification plan and policy and anticipates that the percentage of real estate lending to the overall portfolio will decrease in the future as result of that process. Management had previously reorganized the lending function by targeted business units and has placed increased emphasis upon commercial and industrial lending in particular. This action included strategic additions and changes to staff as well as a prior realignment of resources.

Table of Contents**Securities**

| (in thousands)   | <b>March 31, 2014</b> |                     |                   |                     |                           |
|--|-----------------------|---------------------|-------------------|---------------------|---------------------------|
|  | <b>March 31,</b>      | <b>As of</b>        | <b>March 31,</b>  | <b>December 31,</b> | <b>Dollar Change From</b> |
| <b>Securities available-for-sale, at fair value</b>                      | <b>2014</b>           | <b>December 31,</b> | <b>2013</b>       | <b>2013</b>         | <b>March 31,</b>          |
|  |                       | <b>2013</b>         |                   | <b>2013</b>         | <b>2013</b>               |
| U.S. Treasury  | \$ 1,540              | \$ 1,544            | \$ 1,502          | \$ (4)              | \$ 38                     |
| U.S. government agencies   | 1,665                 | 1,672               | 69,265            | (7)                 | (67,600)                  |
| U.S. government agency mortgage-backed States and political subdivisions | -                     | -                   | 76,352            | -                   | (76,352)                  |
|  | 26,459                | 16,794              | 27,015            | 9,665               | (556)                     |
| Corporate bonds  | 31,272                | 15,102              | 38,579            | 16,170              | (7,307)                   |
| Collateralized mortgage obligations                                      | 51,124                | 63,876              | 131,669           | (12,752)            | (80,545)                  |
| Asset-backed securities  | 288,152               | 273,203             | 220,737           | 14,949              | 67,415                    |
| Collateralized debt obligations  | -                     | -                   | 10,627            | -                   | (10,627)                  |
| <b>Total securities available-for-sale</b>                               | <b>\$ 400,212</b>     | <b>\$ 372,191</b>   | <b>\$ 575,746</b> | <b>\$ 28,021</b>    | <b>\$ (175,534)</b>       |
| <b>Securities held-to-maturity, at amortized cost</b>                    |                       |                     |                   |                     |                           |
| U.S. government agency mortgage-backed                                   | \$ 35,292             | \$ 35,268           | \$ -              | \$ 24               | \$ 35,292                 |
| Collateralized mortgage obligations                                      | 229,006               | 221,303             | -                 | 7,703               | 229,006                   |
| <b>Total securities held-to-maturity</b>                                 | <b>\$ 264,298</b>     | <b>\$ 256,571</b>   | <b>\$ -</b>       | <b>\$ 7,727</b>     | <b>\$ 264,298</b>         |
| <b>Total securities</b>  | <b>\$ 664,510</b>     | <b>\$ 628,762</b>   | <b>\$ 575,746</b> | <b>\$ 35,748</b>    | <b>\$ 88,764</b>          |

Total securities increased from \$628.8 million at December 31, 2013 to \$664.5 million at March 31, 2014. Held-to-Maturity ( HTM ) securities of \$256.6 million at December 31, 2013 saw only one purchase in the quarter a \$9.2 million collateralized mortgage obligation to end the quarter at \$264.3 million. Available-for-Sale ( AFS ) securities were \$372.2 million at December 31, 2013 with purchase activity of two Tax Anticipation Warrants from a local school district, \$20 million in corporate bonds and \$32.9 million in asset-backed securities backed by student loan paper guaranteed by the U.S. Department of Education. AFS security sales activity for the quarter included \$16.6 million in asset-backed securities (backed by government guaranteed student loan paper), an \$11.5 million collateralized mortgage obligation and \$3.7 million in corporate bonds. Total AFS securities were \$400.2 million at March 31, 2014.

First quarter securities activity increased the Company s March 31, 2014, risk weighted assets from December 31, 2013. Increased total holdings and greater amounts of higher risk weighted investments caused the increase in risk weighted assets as reflected in risk based capital ratios. See table above, most notably corporate bonds and state/political subdivisions detail lines.

Additionally, the Company owned securities from five issuers where each issuer holding exceeded 10% of total stockholders equity by a sizeable dollar amount. Company investment managers have assessed the quality of the issuers to confirm that underwriting standards meet expectation and requirements under the Company s investment policy. Further, much of this volume is guaranteed by the U. S. Department of Education.

The net unrealized losses on AFS securities, net of deferred tax benefit, in the portfolio increased by \$600,000 from \$2.4 million as of December 31, 2013, to \$3.0 million as of March 31, 2014. Note 2 of the consolidated financial statements contains additional information related to AFS securities.



**Deposits and Borrowings**

Total deposits increased \$42.2 million, or 2.5%, during the quarter ended March 31, 2014, to \$1.72 billion. During the first quarter, savings, NOW and money market deposit volume increased by \$36.2 million. Time deposits decreased by \$7.8 million, or 1.6%. Noninterest bearing demand deposits increased \$13.7 million, or 3.7%, for the quarter. We continue to be among market share leaders in our home counties of Kane and Kendall in Illinois.

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Average balance for total deposits was \$1.69 billion for the first quarter. This continues the 2013 trend of an average quarterly balance for total deposits of approximately \$1.70 billion. Reductions in average time deposits reflecting maturities of deposits from past higher rate environments continue to be offset by increased volumes in transactional deposit accounts.

One of the Company's most significant borrowing relationships continued to be the \$45.5 million credit facility with Bank of America. That credit facility was originally composed of a \$30.5 million senior debt facility and \$500,000 in term debt, as well as \$45.0 million of Subordinated Debt. The subordinated debt and the term debt portion of the senior debt facility mature on March 31, 2018. The interest rate on the senior debt facility resets quarterly and is based on, at the Company's option, either the lender's prime rate or three-month LIBOR plus 90 basis points. The interest rate on the subordinated debt resets quarterly, and is equal to three-month LIBOR plus 150 basis points. The Company had no outstanding balance on the senior line of credit when it matured but did have \$500,000 in principal outstanding in term debt and \$45.0 million in principal outstanding in subordinated debt at the end of both December 31, 2013, and March 31, 2014. The term debt is secured by all of the outstanding capital stock of the Bank. The Company has made all required interest payments on the outstanding principal amounts on a timely basis.

The credit facility agreement contains usual and customary provisions regarding acceleration of the senior debt upon the occurrence of an event of default. The senior debt agreement also contains certain customary representations and warranties and financial and negative covenants. At March 31, 2014, the Company was out of compliance with one of the financial covenants contained within the credit agreement. Previously, the Company had been out of compliance with two of the financial covenants. The agreement provides that upon an event of default as the result of the Company's failure to comply with a financial covenant, the lender may (i) terminate all commitments to extend further credit, (ii) increase the interest rate on the revolving line of the term debt by 200 basis points, (iii) declare the senior debt immediately due and payable and (iv) exercise all of its rights and remedies at law, in equity and/or pursuant to any or all collateral documents, including foreclosing on the collateral. The total outstanding principal amount of the senior debt is the \$500,000 in term debt. Because the subordinated debt is treated as Tier 2 capital for regulatory capital purposes, the agreement does not provide the lender with any rights of acceleration or other remedies with regard to the subordinated debt upon an event of default caused by the Company's failure to comply with a financial covenant.

The Company increased its securities sold under repurchase agreements \$652,000, or 2.9%, from December 31, 2013. The Company's other short-term borrowings increased \$15.0 million, at March 31, 2014 from December 31, 2013, on a FHLBC advance subsequently matured and not replaced.

**Capital**

As of March 31, 2014, total stockholders' equity was \$149.5 million, which was an increase of \$1.8 million, or 1.2%, from \$147.7 million as of December 31, 2013. This increase was primarily attributable to the net income from operations in the first quarter of 2014. Additionally, total stockholders' equity was affected by the Company not accruing a dividend for the first quarter of 2014 on its Series B Stock. However, on April 15, 2014 the Company declared a dividend of approximately \$15.8 million on the Series B Stock to be paid on May 15, 2014 to Series B Stockholders of record as of May 1, 2014.

On April 28, 2014, the Company repurchased 25,669 shares of the Series B Stock from certain holders, which included certain of the Company's directors, at a repurchase price of 94.75% of the per share liquidation value, or \$947.50 per share, for a total repurchase price of approximately \$24.3 million. The holders of such shares also waived their rights to any dividends on the Series B Stock, and such holders will not receive any part of the declared dividend on the Series B Stock. Payments of \$22.9 million were made to a large private investor with other payments totaling \$1.4 million made to directors of the Company. See Note 17 for additional information.



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As of March 31, 2014, the Company's regulatory ratios of total capital to risk weighted assets, Tier 1 capital to risk weighted assets and Tier 1 leverage increased to 15.87%, 10.85%, and 7.29%, respectively, compared to 15.88%, 10.65%, and 6.96%, respectively, at December 31, 2013. The Company, on a consolidated basis, exceeded the minimum ratios to be deemed adequately capitalized under regulatory defined capital ratios at March 31, 2014. The same capital ratios at the Bank were 17.83%, 16.58% and 11.12%, respectively, at March 31, 2014, compared to 18.04%, 16.78%, and 10.97%, at December 31, 2013.

The Bank is subject to the risk-based capital regulatory guidelines, which include the methodology for calculating the risk-weighting of the Bank's assets, developed by the OCC and the other bank regulatory agencies. In connection with the current economic environment, the Bank's current level of nonperforming assets and the risk-based capital guidelines, the Bank's board of directors has determined that the Bank should maintain a Tier 1 leverage capital ratio at or above eight percent (8%) and a total risk-based capital ratio at or above twelve percent (12%). The Bank currently exceeds those thresholds.

On May 16, 2011, the Bank entered into the Consent Order with the OCC that was terminated on October 17, 2013. Further, in July 2011 the Company entered into the Written Agreement with the Reserve Bank designed to maintain the financial soundness of the Company. In January 2014, the Reserve Bank terminated the Written Agreement. Although the Written Agreement was terminated, the Company expects that it will continue to seek approval from the Reserve Bank prior to paying any dividends on its common stock and incurring any additional indebtedness.

As previously announced in the third quarter of 2010, the Company elected to defer regularly scheduled interest payments on \$58.4 million of junior subordinated debentures related to the trust preferred securities issued by its two statutory trust subsidiaries, Old Second Capital Trust I and Old Second Capital Trust II. Because of the deferral on the subordinated debentures, the trusts will defer regularly scheduled dividends on their trust preferred securities. On April 21, 2014, the Company paid the accumulated and unpaid interest on the trust preferred securities and terminated the deferral period. The interest will not be immediately paid by the indenture trustees to the holders of such trust preferred securities. Instead, the trustees will hold the interest payments in irrevocable deposit accounts and will pay such amounts on the next applicable payment dates under the indentures to holders of the securities on the record dates set forth in the appropriate indenture.

During the fourth quarter 2012, the U.S. Treasury ( Treasury ) announced the continuation of individual auctions of the Series B Stock that was issued through the Troubled Asset Relief Program and Capital Purchase Program (the CPP ). At that time, the Company was informed that the Series B Stock would be auctioned. Auction transactions were settled in first quarter 2013 reflecting Treasury's efforts to conclude the CPP. The auctions were successful for the Treasury as all of the Series B Stock held by Treasury was sold to third parties, including certain of our directors. At December 31, 2013 and March 31, 2014, Old Second Bancorp carried \$72.9 million and \$73.0 million, respectively of Series B Stock in total stockholders equity. Pursuant to the terms of the Series B Stock, the dividends paid on the Series B Stock increased from 5% to 9% in February 2014.

In addition to the above regulatory ratios, the Company's non-GAAP tangible common equity to tangible assets and the Tier 1 common equity to risk weighted assets increased to 3.68% and 1.27%, respectively, at March 31, 2014, compared to 3.67% and 0.77%, respectively, at December 31, 2013. The Company expects that the issuance of 15,525,000 common shares net of repurchasing 25,669 Series B Stock will positively impact the regulatory ratios and the non-GAAP ratios noted above in the quarter ending June 30, 2014. The Company does not anticipate any significant effect to the Bank's regulatory ratios as the Company does not have any immediate plans to use any of the proceeds to increase Bank capital.



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| (dollars in thousands)  | (unaudited)<br>As of March 31, |              | (unaudited)<br>December 31, |  |
|---|--------------------------------|--------------|-----------------------------|--|
|   | 2014                           | 2013         | 2013                        |  |
| <b>Tier 1 capital</b>   |                                |              |                             |  |
| Total stockholders equity   | \$ 149,488                     | \$ 75,854    | \$ 147,692                  |  |
| Tier 1 adjustments:   |                                |              |                             |  |
| Trust preferred securities  | 52,327                         | 26,019       | 51,577                      |  |
| Cumulative other comprehensive loss                                 | 7,493                          | 2,202        | 7,038                       |  |
| Disallowed intangible assets  | (665)                          | (2,751)      | (1,177)                     |  |
| Disallowed deferred tax assets                                      | (66,139)                       | -            | (70,350)                    |  |
| Other   | (561)                          | (447)        | (581)                       |  |
| Tier 1 capital  | \$ 141,943                     | \$ 100,877   | \$ 134,199                  |  |
| <b>Total capital</b>  |                                |              |                             |  |
| Tier 1 capital  | \$ 141,943                     | \$ 100,877   | \$ 134,199                  |  |
| Tier 2 additions:   |                                |              |                             |  |
| Allowable portion of allowance for loan losses                      | 16,467                         | 17,162       | 15,898                      |  |
| Additional trust preferred securities disallowed for tier 1 capital | 4,298                          | 30,606       | 5,048                       |  |
| Subordinated debt   | 45,000                         | 45,000       | 45,000                      |  |
| Tier 2 additions subtotal   | 65,765                         | 92,768       | 65,946                      |  |
| Allowable Tier 2  | 65,765                         | 92,768       | 65,946                      |  |
| Other Tier 2 capital components                                     | (6)                            | (6)          | (6)                         |  |
| Total capital   | \$ 207,702                     | \$ 193,639   | \$ 200,139                  |  |
| <b>Tangible common equity</b>                                       |                                |              |                             |  |
| Total stockholders equity   | \$ 149,488                     | \$ 75,854    | \$ 147,692                  |  |
| Less: Preferred equity  | 73,000                         | 72,130       | 72,942                      |  |
| Intangible assets   | 665                            | 2,751        | 1,177                       |  |
| Tangible common equity  | \$ 75,823                      | \$ 973       | \$ 73,573                   |  |
| <b>Tier 1 common equity</b>   |                                |              |                             |  |
| Tangible common equity  | \$ 75,823                      | \$ 973       | \$ 73,573                   |  |
| Tier 1 adjustments:   |                                |              |                             |  |
| Cumulative other comprehensive loss                                 | 7,493                          | 2,202        | 7,038                       |  |
| Other   | (66,700)                       | (447)        | (70,931)                    |  |
| Tier 1 common equity  | \$ 16,616                      | \$ 2,728     | \$ 9,680                    |  |
| <b>Tangible assets</b>  |                                |              |                             |  |
| Total assets  | \$ 2,059,419                   | \$ 1,954,044 | \$ 2,004,034                |  |
| Less:   |                                |              |                             |  |
| Intangible assets   | 665                            | 2,751        | 1,177                       |  |
| Tangible assets   | \$ 2,058,754                   | \$ 1,951,293 | \$ 2,002,857                |  |
| <b>Total risk-weighted assets</b>                                   |                                |              |                             |  |
| On balance sheet  | \$ 1,268,368                   | \$ 1,316,171 | \$ 1,224,438                |  |
| Off balance sheet   | 40,009                         | 35,327       | 36,023                      |  |
| Total risk-weighted assets  | \$ 1,308,377                   | \$ 1,351,498 | \$ 1,260,461                |  |
| <b>Average assets</b>   |                                |              |                             |  |
| Total average assets for leverage                                   | \$ 1,947,260                   | \$ 1,973,234 | \$ 1,927,217                |  |

In addition, management believes the presentation of other financial measures such as core earnings, which excludes taxes, provisions for loan losses, income and expenses associated with OREO, and other nonrecurring items as detailed immediately below, provides useful supplemental information



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that is helpful in understanding our financial results. Management considers this information useful since certain items such as release for loan losses and OREO activities in the current credit cycle, while somewhat improved, are noteworthy. These disclosures should not be viewed as substitutes for the results determined to be in accordance with GAAP, nor are they necessarily comparable to non-GAAP performance measures that may be presented by other companies.

|  | <b>As of and for the<br/>Three Months Ended<br/>March 31,</b> |             |
|--|---|-------------|
|  | <b>2014</b>   | <b>2013</b> |
|  | <b>(dollars in thousands)<br/>(unaudited)</b>                 |             |
| <b>Core earnings</b>                   |   |             |
| Pre-tax income                         | \$ 3,400  | \$ 5,471    |
| Excluding impact of:                   |   |             |
| Other real estate owned, net of income | 1,008   | 3,097       |
| Loan loss reserve release              | (1,000)   | (2,500)     |
| Litigation related income              | (2)   | (11)        |
| <i>Core Earnings</i>                   | \$ 3,406  | \$ 6,057    |
| <b>Earnings per core diluted share</b> |   |             |
| Average diluted number of shares       | 14,081,634  | 14,157,523  |
| <i>Core diluted earnings per share</i> | \$ 0.24   | \$ 0.43     |



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**Item 3. Quantitative and Qualitative Disclosures about Market Risk**

**Liquidity and Market Risk**

Liquidity is the Company's ability to fund operations, to meet depositor withdrawals, to provide for customer's credit needs, and to meet maturing obligations and existing commitments. The liquidity of the Company principally depends on cash flows from operating activities, investment in and maturity of assets, changes in balances of deposits and borrowings, and its ability to borrow funds. The Company monitors borrowing capacity at correspondent banks as well as the FHLBC and Reserve Bank as part of its liquidity management process as supervised by the Asset and Liability Committee and reviewed by the board of directors.

Net cash outflows from operating activities were \$4.9 million during the first quarter of 2014, compared with net cash inflows of \$2.2 million in the same period in 2013. Proceeds from sales of loans held-for-sale, net of funds used to originate loans held-for-sale, continued to be a source of inflows for both of the first quarters of 2014 and 2013. Interest paid, net of interest received, combined with changes in other assets and liabilities were a source of outflows for both of the first quarters of 2014 and 2013. Management of investing and financing activities, as well as market conditions, determines the level and the stability of net interest cash flows. Management's policy is to mitigate the impact of changes in market interest rates to the extent possible, as part of the balance sheet management process.

Net cash outflows from investing activities were \$46.0 million in the first quarter of 2014, compared to net cash inflows of \$46.7 million in the same period in 2013. In the first quarter 2014, securities transactions accounted for net outflows of \$36.1 million, and net principal received on loans accounted for net outflows of \$15.5 million. In the first quarter of 2013, securities transactions accounted for net inflows of \$9.0 million, and net principal received on loans accounted for net inflows of \$27.0 million. Proceeds from sales of OREO accounted for \$6.0 million and \$11.8 million in investing cash inflows for the first quarters of 2014 and 2013, respectively.

Net cash inflows from financing activities in the first quarter of 2014 were \$57.8 million, compared with net cash outflows of \$96.2 million in the first quarter of 2013. Net deposit inflows in the first quarter of 2014 were \$42.2 million compared to net deposit inflows of \$1.0 million in the first quarter of 2013. Other short-term borrowings had net cash inflows of \$15.0 million related to the FHLBC advance in the first quarter of 2014, whereas the first quarter of 2013 had a cash outflow in other short-term borrowings related to the FHLBC advance repayment of \$100.0 million. Changes in securities sold under repurchase agreements accounted for \$652,000 in net inflows and \$2.9 million in net inflows, respectively, in the first quarters of 2014 and 2013.

**Interest Rate Risk**

As part of its normal operations, the Company is subject to interest-rate risk on the assets it invests in (primarily loans and securities) and the liabilities it funds with (primarily customer deposits and borrowed funds), as well as its ability to manage such risk. Fluctuations in interest rates may result in changes in the fair market values of the Company's financial instruments, cash flows, and net interest income. Like most financial institutions, the Company has an exposure to changes in both short-term and long-term interest rates.

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The Company manages various market risks in its normal course of operations, including credit, liquidity, and interest-rate risk. Other types of market risk, such as foreign currency exchange risk and commodity price risk, do not arise in the normal course of the Company's business activities and operations. In addition, since the Company does not hold a trading portfolio, management believes there is no material exposure to market risk from trading activities. The Company's interest rate risk exposures from March 31, 2014, and December 31, 2013, are outlined in the table below.

The Company's net income can be significantly influenced by a variety of external factors,

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including: overall economic conditions, policies and actions of regulatory authorities, the amounts of and rates at which assets and liabilities reprice, variances in prepayment of loans and securities other than those that are assumed, early withdrawal of deposits, exercise of call options on borrowings or securities, competition, a general rise or decline in interest rates, changes in the slope of the yield-curve, changes in historical relationships between indices (such as LIBOR and prime), and balance sheet growth or contraction. The Company's Asset and Liability Committee seeks to manage interest rate risk under a variety of rate environments by structuring the Company's balance sheet and off-balance sheet positions, which includes interest rate swap derivatives as discussed in Note 13 of the financial statements included in this quarterly report. The Company monitors and manages this risk within approved policy limits.

The Company utilizes simulation analysis to quantify the impact of various rate scenarios on net interest income. The simulation model incorporates specific cash flows, repricing characteristics, and embedded options of the assets and liabilities held by the Company. Earnings at risk is calculated by comparing the net interest income of a stable interest rate environment to the net interest income of different interest rate environments to determine the percentage change. Significant declines in interest rates that occurred during the first half of 2012 had made it impossible to calculate valid interest rate scenarios for rate declines of 1.0% or more. Compared to December 31, 2013 the Company had less earnings gains (in both dollars and percentage) if interest rates should rise. This decrease in rising-rate benefit reflects continued customer demand for longer term, fixed-rate loans. Federal Funds rates and the Bank's prime rate were stable throughout the first quarter of 2014, at 0.25% and 3.25%, respectively.

The following table summarizes the effect on annual income before income taxes based upon an immediate increase or decrease in interest rates of 0.5%, 1%, and 2% assuming no change in the slope of the yield curve. The -2% and -1% sections of the table do not show model changes for those magnitudes of decrease due to the low interest rate environment over the relevant time periods. While it was not possible to calculate net interest income for -0.5% as of December 31, 2013, increases in interest rates during the first quarter of 2014 made that calculation possible as of March 31, 2014, which is reflected in the table.

**Analysis of Net Interest Income Sensitivity**

|                          | <b>Immediate Changes in Rates</b> |       |          |         |         |          |
|--------------------------|-----------------------------------|-------|----------|---------|---------|----------|
|                          | -2.0%                             | -1.0% | -0.5%    | 0.5%    | 1.0%    | 2.0%     |
| <b>March 31, 2014</b>    |                                   |       |          |         |         |          |
| Dollar change            | N/A                               | N/A   | \$ (478) | \$ (80) | \$ (59) | \$ 705   |
| Percent change           | N/A                               | N/A   | -0.8%    | -0.1%   | -0.1%   | +1.2%    |
| <b>December 31, 2013</b> |                                   |       |          |         |         |          |
| Dollar change            | N/A                               | N/A   | N/A      | \$ 70   | \$ 249  | \$ 1,190 |
| Percent change           | N/A                               | N/A   | N/A      | +0.1%   | +0.4%   | +2.1%    |

The amounts and assumptions used in the simulation model should not be viewed as indicative of expected actual results. Actual results will differ from simulated results due to timing, magnitude and frequency of interest rate changes as well as changes in market conditions and management strategies. The above results do not take into account any management action to mitigate potential risk.

**Item 4. Controls and Procedures**

**Evaluation of Disclosure Controls and Procedures**

The Chief Executive Officer and Chief Financial Officer have evaluated the effectiveness of the design and operation of the Company's disclosure controls and procedures, as defined in Rule 13a-15(e) promulgated under the Securities and Exchange Act of 1934, as amended, as of March 31, 2014. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that as of March 31, 2014, the Company's internal controls were effective to ensure that information required to be disclosed by the Company in reports that it files or submits under the Securities and Exchange Act of 1934 is recorded, processed, summarized, and reported within the time periods specified.

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There were no changes in the Company's internal control over financial reporting during the quarter ended March 31, 2014, that have materially affected, or are reasonably likely to affect, the Company's internal control over financial reporting.

**Forward-looking Statements**

This document (including information incorporated by reference) contains, and future oral and written statements of the Company and its management may contain, forward-looking statements, within the meaning of such term in the Private Securities Litigation Reform Act of 1995, with respect to the financial condition, results of operations, plans, objectives, future performance and business of the Company. Forward-looking statements, which may be based upon beliefs, expectations and assumptions of the Company's management and on information currently available to management, are generally identifiable by the use of words such as believe, expect, anticipate, plan, intend, estimate, will, would, could, should or other similar expressions. Additionally, all statements in this document, including forward-looking statements, speak only as of the date they are made, and the Company undertakes no obligation to update any statement in light of new information or future events.

The Company's ability to predict results or the actual effect of future plans or strategies is inherently uncertain. The factors, which could have a material adverse effect on the operations and future prospects of the Company and its subsidiaries, are detailed in the Risk Factors section included under Item 1A. of Part I of the Company's Form 10-K. In addition to the risk factors described in that section, there are other factors that may impact any public company, including ours, which could have a material adverse effect on the operations and future prospects of the Company and its subsidiaries. These risks and uncertainties should be considered in evaluating forward-looking statements and undue reliance should not be placed on such statements.

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**PART II - OTHER INFORMATION**

**Item 1. Legal Proceedings**

The Company and its subsidiaries, from time to time, are involved in collection suits in the ordinary course of business against its debtors and are defendants in legal actions arising from normal business activities. Management, after consultation with legal counsel, believes that the ultimate liabilities, if any, resulting from these actions will not have a material adverse effect on the financial position of the Bank or on the consolidated financial position of the Company.

**Item 1.A. Risk Factors**

There have been no material changes from the risk factors set forth in Part I, Item 1.A. Risk Factors, of the Company's Form 10-K for the year ended December 31, 2013. Please refer to that section of the Company's Form 10-K for disclosures regarding the risks and uncertainties related to the Company's business.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

None.

**Item 3. Defaults Upon Senior Securities**

None.

**Item 4. Mine Safety Disclosures**

N/A

**Item 5. Other Information**

None.

**Item 6. Exhibits**

**Exhibits:**

31.1 Certification of Chief Executive Officer Pursuant to Rule 13a-14(a)/15d-14(a)

31.2 Certification of Chief Financial Officer Pursuant to Rule 13a-14(a)/15d-14(a)

32.1 Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

32.2 Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

101 Interactive data files pursuant to Rule 405 of Regulation S-T: (i) Consolidated Balance Sheets at March 31, 2014, and December 31, 2013; (ii) Consolidated Statements of Operations for the three ended March 31, 2014, and March 31, 2013; (iii) Consolidated Statements of Stockholders Equity for the three months ended March 31, 2014, and March 31, 2013; (iv) Consolidated Statements of Cash Flows for the three months ended March 31, 2014, and March 31, 2013; and (v) Notes to Consolidated Financial Statements, tagged as blocks of text and in detail.\*

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\* As provided in Rule 406T of Regulation S-T, these interactive data files shall not be deemed filed for purposes of Sections 11 and 12 of the Securities Act of 1933 and Section 18 of the Securities Exchange Act of 1934 as amended, or otherwise subject to liability under those sections.



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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.

OLD SECOND BANCORP, INC.

BY: /s/ William B. Skoglund  
William B. Skoglund  
  
Chairman of the Board, Director  
President and Chief Executive Officer  
(principal executive officer)

BY: /s/ J. Douglas Cheatham  
J. Douglas Cheatham  
  
Executive Vice-President and  
Chief Financial Officer, Director  
(principal financial and accounting  
officer)

DATE: May 13, 2014