

OLD SECOND BANCORP INC

Form 10-Q

November 12, 2014

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I

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2014

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

36-3143493

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(State or other jurisdiction of incorporation or organization) (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

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 Exchange Act Rule 12b-2).

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 November 7, 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 - FINANCIAL INFORMATION

## Item 1. Financial Statements

Old Second Bancorp, Inc. and Subsidiaries

Consolidated Balance Sheets

(In thousands, except share data)

	(Unaudited) September 30, 2014	December 31, 2013
Assets		
Cash and due from banks	\$ 33,260	\$ 33,210
Interest bearing deposits with financial institutions	10,797	14,450
Cash and cash equivalents	44,057	47,660
Securities available-for-sale, at fair value	362,243	372,191
Securities held-to-maturity, at amortized cost	263,040	256,571
Federal Home Loan Bank and Federal Reserve Bank stock	9,058	10,292
Loans held-for-sale	3,422	3,822
Loans	1,140,882	1,101,256
Less: allowance for loan losses	23,330	27,281
Net loans	1,117,552	1,073,975
Premises and equipment, net	42,557	46,005
Other real estate owned	40,877	41,537
Mortgage servicing rights, net	5,640	5,807
Core deposit, net	-	1,177
Bank-owned life insurance (BOLI)	56,438	55,410
Deferred tax assets, net	71,375	75,303
Other assets	16,840	14,284
Total assets	\$ 2,033,099	\$ 2,004,034
Liabilities		
Deposits:		
Noninterest bearing demand	\$ 380,687	\$ 373,389
Interest bearing:		
Savings, NOW, and money market	848,372	836,300
Time	427,696	472,439
Total deposits	1,656,755	1,682,128
Securities sold under repurchase agreements	29,438	22,560
Other short-term borrowings	40,000	5,000
Junior subordinated debentures	58,378	58,378
Subordinated debt	45,000	45,000
Notes payable and other borrowings	500	500

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Other liabilities	10,337	42,776
Total liabilities	1,840,408	1,856,342
Stockholders' Equity		
Preferred stock	47,331	72,942
Common stock	34,365	18,830
Additional paid-in capital	115,290	66,212
Retained earnings	98,786	92,549
Accumulated other comprehensive loss	(7,232)	(7,038)
Treasury stock	(95,849)	(95,803)
Total stockholders' equity	192,691	147,692
Total liabilities and stockholders' equity	\$ 2,033,099	\$ 2,004,034

	September 30, 2014		December 31, 2013	
	Preferred Stock \$ 1	Common Stock \$ 1	Preferred Stock \$ 1	Common Stock \$ 1
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	47,331	34,364,734	73,000	18,829,734
Shares outstanding	47,331	29,442,508	73,000	13,917,108
Treasury shares	-	4,922,226	-	4,912,626

See accompanying notes to consolidated financial statements.

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Old Second Bancorp, Inc. and Subsidiaries

Consolidated Statements of Operations

(In thousands, except share data)

	(unaudited) Three Months Ended September 30,		(unaudited) Nine Months Ended September 30,	
	2014	2013	2014	2013
Interest and dividend income				
Loans, including fees	\$ 13,362	\$ 14,327	\$ 39,346	\$ 43,153
Loans held-for-sale	38	38	92	124
Securities:				
Taxable	3,586	3,113	10,440	8,109
Tax exempt	110	148	376	441
Dividends from Federal Reserve Bank and Federal Home Loan Bank stock	78	76	232	228
Interest bearing deposits with financial institutions	25	22	60	91
Total interest and dividend income	17,199	17,724	50,546	52,146
Interest expense				
Savings, NOW, and money market deposits	175	206	562	655
Time deposits	1,073	1,674	3,604	5,327
Other short-term borrowings	5	6	10	26
Junior subordinated debentures	1,072	1,336	3,847	3,937
Subordinated debt	199	209	593	610
Notes payable and other borrowings	4	4	12	12
Total interest expense	2,528	3,435	8,628	10,567
Net interest and dividend income	14,671	14,289	41,918	41,579
Loan loss reserve release	-	(1,750)	(2,000)	(6,050)
Net interest and dividend income after provision for loan losses	14,671	16,039	43,918	47,629
Noninterest income				
Trust income	1,483	1,494	4,619	4,666
Service charges on deposits	1,838	1,904	5,354	5,379
Secondary mortgage fees	174	183	441	680
Mortgage servicing gain, net of changes in fair value	252	235	269	1,222
Net gain on sales of mortgage loans	914	814	2,614	4,601
Securities gains (loss), net	1,231	(7)	1,457	2,191
Increase in cash surrender value of bank-owned life insurance	304	419	1,028	1,198
Death benefit realized on bank-owned life insurance	-	6	-	381
Debit card interchange income	1,011	873	2,771	2,565
Other income	1,116	1,549	3,572	4,434
Total noninterest income	8,323	7,470	22,125	27,317
Noninterest expense				

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Salaries and employee benefits	8,856	9,299	27,140	27,508
Occupancy expense, net	1,143	1,266	3,809	3,787
Furniture and equipment expense	989	1,026	2,956	3,274
FDIC insurance	649	987	1,555	3,046
General bank insurance	371	489	1,203	1,829
Amortization of core deposit	154	524	1,177	1,574
Advertising expense	291	347	1,053	841
Debit card interchange expense	418	366	1,208	1,072
Legal fees	332	615	998	1,424
Other real estate expense, net	2,007	2,544	4,665	8,943
Other expense	3,134	3,119	9,148	9,773
Total noninterest expense	18,344	20,582	54,912	63,071
Income before income taxes	4,650	2,927	11,131	11,875
Provision (benefit) for income taxes	1,726	(69,997)	3,984	(69,997)
Net income	\$ 2,924	\$ 72,924	\$ 7,147	\$ 81,872
Preferred stock dividends and accretion of discount	1,065	1,323	3,985	3,917
Dividends waived upon preferred stock redemption	-	-	(5,433)	-
Gain on preferred stock redemption	-	-	(1,348)	-
Net income available to common stockholders	\$ 1,859	\$ 71,601	\$ 9,943	\$ 77,955
Basic earnings per share	\$ 0.06	\$ 5.08	\$ 0.41	\$ 5.52
Diluted earnings per share	0.06	5.08	0.41	5.52

See accompanying notes to consolidated financial statements.



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Old Second Bancorp, Inc. and Subsidiaries

Consolidated Statements of Comprehensive Income (Loss)

(In thousands)

	(Unaudited) Three Months Ended September 30,		(Unaudited) Nine Months Ended September 30,	
	2014	2013	2014	2013
Net Income	\$ 2,924	\$ 72,924	\$ 7,147	\$ 81,872
Unrealized holding (losses) gains on available-for-sale securities arising during the period	(2,224)	(3,411)	397	(16,780)
Related tax benefit (expense)	918	1,405	(161)	6,913
Holding (losses) gains after tax on available-for-sale securities	(1,306)	(2,006)	236	(9,867)
Less: Reclassification adjustment for the net gains realized during the period				
Net realized gains (losses)	1,231	(7)	1,457	2,191
Income tax (expense) benefit on net realized gains (losses)	(504)	3	(597)	(899)
Net realized gains (losses) after tax	727	(4)	860	1,292
Other comprehensive loss on available-for-sale securities	(2,033)	(2,002)	(624)	(11,159)
Accretion of net unrealized holding losses on held-to-maturity transferred from available-for-sale securities	237	87	731	87
Related tax expense	(97)	(36)	(301)	(36)
Other comprehensive income on held-to-maturity securities	140	51	430	51
Total other comprehensive loss	(1,893)	(1,951)	(194)	(11,108)
Total comprehensive income	\$ 1,031	\$ 70,973	\$ 6,953	\$ 70,764

See accompanying notes to consolidated financial statements.

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Old Second Bancorp, Inc. and Subsidiaries

Consolidated Statements of Cash Flows

(In thousands)

	(Unaudited)	
	Nine Months Ended	
	September 30,	
	2014	2013
Cash flows from operating activities		
Net income	\$ 7,147	\$ 81,872
Adjustments to reconcile net income to net cash (used in) provided by operating activities:		
Depreciation and amortization of leasehold improvement	1,887	2,147
Change in fair value of mortgage servicing rights	761	(81)
Loan loss reserve release	(2,000)	(6,050)
Gain on recapture of restricted stock	-	(612)
Provision for deferred tax expense (benefit)	4,063	(70,161)
Originations of loans held-for-sale	(85,172)	(151,601)
Proceeds from sales of loans held-for-sale	87,569	160,966
Net gain on sales of mortgage loans	(2,614)	(4,601)
Change in current income taxes payable	(79)	(101)
Increase in cash surrender value of bank-owned life insurance	(1,028)	(1,198)
Death claim on bank-owned life insurance	-	396
Change in accrued interest receivable and other assets	(3,633)	(334)
Change in accrued interest payable and other liabilities	(22,108)	4,341
Net discount accretion on securities	(1,408)	(131)
Securities gains, net	(1,457)	(2,191)
Amortization of core deposit	1,177	1,574
Stock based compensation	189	123
Net gain on sale of other real estate owned	(610)	(1,175)
Provision for other real estate owned losses	2,781	6,537
Net gain on disposal of fixed assets	-	(5)
Loss on transfer of premises to other real estate owned	121	-
Net cash (used in) provided by operating activities	(14,414)	19,715
Cash flows from investing activities		
Proceeds from maturities and calls including pay down of securities available-for-sale	15,430	38,175
Proceeds from sales of securities available-for-sale	264,502	484,112
Purchases of securities available-for-sale	(268,639)	(564,372)
Proceeds from maturities and calls including pay down of securities held-to-maturity	5,934	541
Purchases of securities held-to-maturity	(11,212)	(21,382)
Proceeds from sales of Federal Home Loan Bank stock	1,234	910
Net change in loans	(53,037)	49,885
Improvements in other real estate owned	(637)	(60)

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Proceeds from sales of other real estate owned	12,746	32,103
Proceeds from disposition of fixed assets	1	6
Net purchases of premises and equipment	(721)	(1,538)
Net cash (used in) provided by investing activities	(34,399)	18,380
Cash flows from financing activities		
Net change in deposits	(25,373)	(44,096)
Net change in securities sold under repurchase agreements	6,878	2,844
Net change in other short-term borrowings	35,000	(45,000)
Redemption of preferred stock	(24,321)	-
Proceeds from issuance of common stock	64,395	-
Dividends paid	(11,323)	-
Purchase of treasury stock	(46)	(278)
Net cash provided by (used in) financing activities	45,210	(86,530)
Net change in cash and cash equivalents	(3,603)	(48,435)
Cash and cash equivalents at beginning of period	47,660	128,507
Cash and cash equivalents at end of period	\$ 44,057	\$ 80,072

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Old Second Bancorp, Inc. and Subsidiaries

Consolidated Statements of Cash Flows - Continued

(In thousands)

	(Unaudited)	
	Nine Months Ended	
	September 30,	
Supplemental cash flow information	2014	2013
Income taxes paid	\$ -	\$ 266
Interest paid for deposits	4,412	6,144
Interest paid for borrowings	21,425	656
Non-cash transfer of loans to other real estate owned	11,460	14,196
Non-cash transfer of premises to other real estate owned	2,160	-
Non-cash transfer of loans to securities available-for-sale	-	5,329
Non-cash transfer of securities available-for-sale to securities held-to-maturity	-	237,154
Change in dividends accrued and declared but not paid	(9,123)	510
Accretion on preferred stock discount	58	798
Fair value difference on recapture of restricted stock	-	43

See accompanying notes to consolidated financial statements.

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Old Second Bancorp, Inc. and Subsidiaries

Consolidated Statements of Changes in

Stockholders' Equity

(In thousands)

	Common Stock	Preferred Stock	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Treasury Stock	Total Stockholders' Equity
Balance, December 31, 2012	\$ 18,729	\$ 71,869	\$ 66,189	\$ 12,048	\$ (1,327)	\$ (94,956)	\$ 72,552
Net income				81,872			81,872
Other comprehensive loss, net of tax					(11,108)		(11,108)
Change in restricted stock	101		(101)				-
Recapture of restricted stock			(43)			(569)	(612)
Stock based compensation			123				123
Purchase of treasury stock						(278)	(278)
Preferred stock accretion and declared dividends		798		(1,308)			(510)
Balance, September 30, 2013	\$ 18,830	\$ 72,667	\$ 66,168	\$ 92,612	\$ (12,435)	\$ (95,803)	\$ 142,039
Balance, December 31, 2013	\$ 18,830	\$ 72,942	\$ 66,212	\$ 92,549	\$ (7,038)	\$ (95,803)	\$ 147,692
Net income				7,147			7,147
Other comprehensive loss, net of tax					(194)		(194)
Change in restricted stock	10		(10)				-
Tax effect from vesting of restricted stock			29				29

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Stock based compensation			189				189
Purchase of treasury stock					(46)		(46)
Redemption of preferred stock		(25,669)		1,348			(24,321)
Common stock offering	15,525		48,870				64,395
Preferred stock accretion and declared dividends		58		(2,258)			(2,200)
Balance, September 30, 2014	\$ 34,365	\$ 47,331	\$ 115,290	\$ 98,786	\$ (7,232)	\$ (95,849)	\$ 192,691

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 consolidated financial statements are consistent with those used in the preparation of the annual financial information. The interim consolidated 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 September 30, 2014, are not necessarily indicative of the results that may be expected for the year ending December 31, 2014. These interim consolidated financial statements are unaudited and 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 to the consolidated financial statements 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 United States generally accepted accounting principles ("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 consolidated financial statements and accompanying notes. These estimates, assumptions, and judgments are based on information available as of the date of the consolidated financial statements. Future changes in information may affect these estimates, assumptions, and judgments, which, in turn, may affect amounts reported in the consolidated 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 consolidated 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 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.

In May 2014, the FASB issued ASU No. 2014-09 "Revenue from Contracts with Customers (Topic 606)." The core principle of the guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods and services. ASU 2014-09 is effective for annual reporting periods beginning after December 15, 2016, including interim periods within that reporting period. The amendments can be applied retrospectively to each prior reporting period or retrospectively with the cumulative effect of initially applying this update recognized at the date of initial application. Early application is not permitted. The Company is assessing the impact of ASU 2014-09 on its accounting and disclosures.



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In June 2014, FASB issued Accounting Standards Update (ASU) No. 2014-12 "Compensation - Stock Compensation (Topic 718) - Accounting for Share Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period." ASU 2014-12 requires that a performance target that affects vesting and that could be achieved after the requisite service period be treated as a performance condition. ASU 2014-12 is effective for interim and annual periods beginning after December 15, 2015. The amendments can be applied prospectively to all awards granted or modified after the effective date or retrospectively to all awards with performance targets that are outstanding as of the beginning of the earliest annual period presented and to all new or modified awards thereafter. Early adoption is permitted. The adoption of this standard is not expected to have a material effect to the Company's operating results or financial condition.

In August 2014, FASB issued ASU No. 2014-15 "Presentation of Financial Statements—Going Concern (Subtopic 205-40) Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern." ASU 2014-15 provide guidance in GAAP about management's responsibility to evaluate whether there is substantial doubt about an entity's ability to continue as a going concern and to provide related footnote disclosures. ASU 2014-15 is effective for interim and annual periods beginning after December 15, 2016. The amendments in this Update are effective for the annual period ending after December 15, 2016, and for annual periods and interim periods thereafter. Early application is permitted. 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.

Nonmarketable equity investments include Federal Home Loan Bank of Chicago (“FHLBC”) stock and Federal Reserve Bank of Chicago (“Reserve Bank”) stock. FHLBC stock was recorded at \$4.3 million and \$5.5 million at September 30, 2014, and December 31, 2013, respectively. Reserve Bank stock was recorded at \$4.8 million at September 30, 2014, and December 31, 2013. Our FHLBC stock is necessary to maintain access to FHLBC advances.

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The following table summarizes the amortized cost and fair value of the securities portfolio at September 30, 2014 and December 31, 2013 and the corresponding amounts of gross unrealized gains and losses (in thousands):

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
September 30, 2014:				
Securities Available-for-Sale				
U.S. Treasury	\$ 1,533	\$ -	\$ (1)	\$ 1,532
U.S. government agencies	1,718	-	(80)	1,638
States and political subdivisions	13,794	313	(228)	13,879
Corporate bonds	31,272	65	(556)	30,781
Collateralized mortgage obligations	29,951	41	(1,575)	28,417
Asset-backed securities	194,927	98	(2,227)	192,798
Collateralized loan obligations	94,202	-	(1,004)	93,198
Total Securities Available-for-Sale	\$ 367,397	\$ 517	\$ (5,671)	\$ 362,243
Securities Held-to-Maturity				
U.S. government agency mortgage-backed	\$ 37,321	\$ 1,346	\$ (11)	\$ 38,656
Collateralized mortgage obligations	225,719	2,017	(2,049)	225,687
Total Securities Held-to-Maturity	\$ 263,040	\$ 3,363	\$ (2,060)	\$ 264,343
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
December 31, 2013:				
Securities Available-for-Sale				
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
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 September 30, 2014, by contractual maturity, were as follows in the table below. Securities not due at a single maturity date are shown separately.

	Amortized Cost	Weighted Average Yield	Fair Value
Securities Available-for-Sale			
Due in one year or less	\$ 410	4.50%	\$ 421
Due after one year through five years	5,811	2.87%	5,992
Due after five years through ten years	36,724	2.44%	36,218
Due after ten years	5,372	3.31%	5,199
	48,317	2.61%	47,830
Collateralized mortgage obligations	29,951	2.46%	28,417
Asset-back securities	194,927	2.10%	192,798
Collateralized loan obligations	94,202	2.78%	93,198
	\$ 367,397	2.37%	\$ 362,243
Securities Held-to-Maturity			
Mortgage-backed and collateralized mortgage obligations	\$ 263,040	3.05%	\$ 264,343

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Securities with unrealized losses at September 30, 2014, and December 31, 2013, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, were as follows (in thousands except for number of securities):

September 30, 2014	Less than 12 months in an unrealized loss position			Greater than 12 months in an unrealized loss position			Total Number of	Unrealized	Fair
	Number of	Unrealized	Fair	Number of	Unrealized	Fair			
Securities									
Available-for-Sale	Securities	Losses	Value	Securities	Losses	Value	Securities	Losses	Value
Treasury	1	\$ 1	\$ 1,532	-	\$ -	\$ -	1	\$ 1	\$ 1,532
Government									
Securities	-	-	-	1	80	1,638	1	80	1,638
and political									
derivatives	3	215	4,450	2	13	1,862	5	228	6,312
Corporate bonds	5	463	20,581	2	93	2,411	7	556	22,992
Generalized									
collateral	1	18	4,739	3	1,557	21,704	4	1,575	26,443
Asset-backed									
Securities	10	1,231	117,440	3	996	44,042	13	2,227	161,482
Generalized loan									
derivatives	13	1,004	93,198	-	-	-	13	1,004	93,198
Securities	33	\$ 2,932	\$ 241,940	11	\$ 2,739	\$ 71,657	44	\$ 5,671	\$ 313,597
Securities									
Non-Maturity									
Government									
Securities									
Asset-backed	1	\$ 11	\$ 1,972	-	\$ -	\$ -	1	\$ 11	\$ 1,972
Generalized									
collateral									
derivatives	13	1,164	83,545	2	885	37,828	15	2,049	121,373
Securities	14	\$ 1,175	\$ 85,517	2	\$ 885	\$ 37,828	16	\$ 2,060	\$ 121,373

December 31, 2013	Less than 12 months in an unrealized loss position			Greater than 12 months in an unrealized loss position			Total Number of	Unrealized	Fair
	Number of	Unrealized	Fair	Number of	Unrealized	Fair			
Securities									
Available-for-Sale	Securities	Losses	Value	Securities	Losses	Value	Securities	Losses	Value
Treasury	1	\$ 5	\$ 1,544	-	\$ -	\$ -	1	\$ 5	\$ 1,544
Securities	-	-	-	1	66	1,672	1	66	1,672

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government securities									
and political divisions	6	217	4,625	-	-	-	6	217	4,625
corporate bonds	4	429	10,493	2	219	2,796	6	648	13,289
sterilized									
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	\$ 180,655
securities									
short-to-Maturity									
government securities									
collateralized mortgage-backed securities	6	\$ 73	\$ 19,134	-	\$ -	\$ -	6	\$ 73	\$ 19,134
sterilized									
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 nine months ended September 30, 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:

	September 30, 2014	December 31, 2013
Commercial	\$ 106,592	\$ 94,736
Real estate - commercial	600,649	560,233
Real estate - construction	41,936	29,351
Real estate - residential	365,602	390,201
Consumer	3,142	2,760
Overdraft	1,198	628
Lease financing receivables	8,398	10,069
Other	12,757	12,793
	1,140,274	1,100,771
Net deferred loan fees	608	485
	\$ 1,140,882	\$ 1,101,256

It is the policy of the Company to review each prospective credit in order to determine if an adequate level of security or collateral was obtained prior to making a loan. The type of collateral, when 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 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 88.4% and 89.0% of the portfolio at September 30, 2014, and December 31, 2013, respectively.

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

September 30, 2014	90 Days or Greater Past				Current	Nonaccrual	Total Loans	Recorded Investment 90 days or Greater Past Due and Accruing
	30-59 Days Past	60-89 Days Past Due	Due	Total Past Due				
Commercial	\$ 99	\$ -	\$ -	\$ 99	\$ 113,246	\$ 1,645	\$ 114,990	\$ -
Real estate - commercial								
Owner occupied general purpose	32	-	-	32	132,123	5,973	138,128	-
Owner occupied special purpose	-	-	-	-	166,561	3,802	170,363	-
Non-owner occupied general purpose	-	-	-	-	150,073	6,421	156,494	-
Non-owner occupied special purpose	-	-	-	-	84,410	1,472	85,882	-
Retail properties	-	-	-	-	34,692	-	34,692	-
Farm	-	-	-	-	15,090	-	15,090	-
Real estate - construction								
Homebuilder	-	-	-	-	3,232	-	3,232	-
Land	-	-	-	-	1,684	209	1,893	-
Commercial speculative	-	-	-	-	15,859	-	15,859	-
All other	-	-	-	-	20,367	585	20,952	-
Real estate - residential								
Investor	173	722	-	895	127,490	1,901	130,286	-
Owner occupied	96	230	-	326	109,990	7,204	117,520	-
Revolving and junior liens	105	78	44	227	115,273	2,296	117,796	44
Consumer	6	-	-	6	3,136	-	3,142	-
All other	-	-	-	-	14,563	-	14,563	-
	\$ 511	\$ 1,030	\$ 44	\$ 1,585	\$ 1,107,789	\$ 31,508	\$ 1,140,882	\$ 44



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December 31, 2013	90 Days or Greater Past				Current	Nonaccrual	Total Loans	Recorded Investment 90 days or Greater Past Due and Accruing
	30-59 Days Past	60-89 Days Past Due	Due	Total Past Due				
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	-
Non-owner occupied special purpose	-	-	-	-	73,325	661	73,986	-
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
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 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. This

analysis includes loans with outstanding balances or commitments greater than \$50,000 and excludes homogeneous loans such as home equity lines 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.

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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.

Credit Quality Indicators by class of loans were as follows:

September 30, 2014	Pass	Special Mention	Substandard 1	Doubtful	Total
Commercial	\$ 106,620	\$ 4,119	\$ 4,251	\$ -	\$ 114,990
Real estate - commercial					
Owner occupied general purpose	129,530	913	7,685	-	138,128
Owner occupied special purpose	151,663	12,558	6,142	-	170,363
Non-owner occupied general purpose	145,153	1,872	9,469	-	156,494
Non-owner occupied special purpose	76,267	8,143	1,472	-	85,882
Retail Properties	32,450	2,242	-	-	34,692
Farm	15,090	-	-	-	15,090
Real estate - construction					
Homebuilder	3,232	-	-	-	3,232
Land	1,684	-	209	-	1,893
Commercial speculative	11,815	540	3,504	-	15,859
All other	20,367	-	585	-	20,952
Real estate - residential					
Investor	126,879	-	3,407	-	130,286
Owner occupied	109,723	-	7,797	-	117,520
Revolving and junior liens	113,933	188	3,675	-	117,796
Consumer	3,141	-	1	-	3,142
All other	14,563	-	-	-	14,563
Total	\$ 1,062,110	\$ 30,575	\$ 48,197	\$ -	\$ 1,140,882

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December 31, 2013	Pass	Special 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 September 30, 2014			Nine Months Ended September 30, 2014	
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded					
Commercial	\$ 1,645	\$ 2,173	\$ -	\$ 836	\$ -
Commercial real estate					
Owner occupied general purpose	7,176	7,840	-	4,860	81
Owner occupied special purpose	3,217	4,147	-	3,294	-
Non-owner occupied general purpose	7,065	8,052	-	6,246	45
Non-owner occupied special purpose	1,472	1,935	-	1,067	-
Retail properties	-	-	-	1,572	-
Farm	-	-	-	-	-
Construction					
Homebuilder	1,791	1,791	-	1,903	69
Land	209	312	-	209	-
Commercial speculative	-	-	-	369	-
All other	306	347	-	155	-
Residential					
Investor	2,553	3,538	-	4,269	32
Owner occupied	11,735	13,214	-	10,457	128
Revolving and junior liens	2,028	3,163	-	1,899	4
Consumer	-	-	-	-	-
Total impaired loans with no recorded allowance	39,197	46,512	-	37,136	359
With an allowance recorded					
Commercial	-	-	-	-	-
Commercial real estate					
Owner occupied general purpose	-	-	-	365	-
Owner occupied special purpose	585	676	167	2,443	-
Non-owner occupied general purpose	-	-	-	469	-
Non-owner occupied special purpose	-	-	-	-	-
Retail properties	-	-	-	-	-
Farm	-	-	-	-	-
Construction					
Homebuilder	-	-	-	84	-
Land	-	-	-	-	-
Commercial speculative	-	-	-	588	-
All other	279	312	107	357	-
Residential					
Investor	139	149	79	412	-
Owner occupied	259	394	59	912	15

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Revolving and junior liens	327	358	129	912	-
Consumer	-	-	-	-	-
Total impaired loans with a recorded allowance	1,589	1,889	541	6,542	15
Total impaired loans	\$ 40,786	\$ 48,401	\$ 541	\$ 43,678	\$ 374

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Impaired loans by class of loans were as follows:

	As of December 31, 2013			Nine Months Ended September 30, 2013	
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded					
Commercial	\$ 27	\$ 34	\$ -	\$ 113	\$ -
Commercial real estate					
Owner occupied general purpose	2,543	3,006	-	3,565	3
Owner occupied special purpose	3,371	4,117	-	5,913	-
Non-owner occupied general purpose	5,428	6,709	-	11,995	113
Non-owner occupied special purpose	661	919	-	457	-
Retail properties	3,144	3,811	-	6,918	-
Farm	-	-	-	1,259	-
Construction					
Homebuilder	2,016	2,016	-	3,597	120
Land	209	308	-	231	-
Commercial speculative	738	742	-	2,089	-
All other	4	35	-	188	-
Residential					
Investor	5,984	8,338	-	5,845	-
Owner occupied	9,179	10,451	-	9,606	151
Revolving and junior liens	1,771	2,313	-	1,668	5
Consumer	-	-	-	12	-
Total impaired loans with no recorded allowance	35,075	42,799	-	53,456	392
With an allowance recorded					
Commercial	-	-	-	283	-
Commercial real estate					
Owner occupied general purpose	730	792	264	974	-
Owner occupied special purpose	4,300	4,702	759	2,777	-
Non-owner occupied general purpose	939	1,030	129	1,481	-
Non-owner occupied special purpose	-	-	-	-	-
Retail properties	-	-	-	876	-
Farm	-	-	-	-	-
Construction					
Homebuilder	168	604	76	97	-
Land	-	-	-	-	-
Commercial speculative	1,175	1,808	17	2,971	-
All other	436	468	262	465	-
Residential					
Investor	684	913	160	3,263	-
Owner occupied	1,565	1,831	170	3,448	12

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Revolving and junior liens	1,498	1,848	558	1,527	-
Consumer	-	-	-	-	-
Total impaired loans with a recorded allowance	11,495	13,996	2,395	18,162	12
Total impaired loans	\$ 46,570	\$ 56,795	\$ 2,395	\$ 71,618	\$ 404

Troubled debt restructurings (“TDRs”) 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 reduction in interest rates, extension of term, deferrals of principal, and other modifications. The Bank participates 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 a TDR is determined by either 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 on 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.



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TDRs that were modified during the period are as follows:

	TDR Modifications Three Months Ended September 30, 2014			TDR Modifications Nine Months Ended September 30, 2014		
	# of contracts	Pre-modification recorded investment	Post-modification recorded investment	# of contracts	Pre-modification recorded investment	Post-modification recorded investment
Troubled debt restructurings						
Real estate - commercial						
Other1	-	\$ -	\$ -	2	\$ 1,320	\$ 1,118
Real estate - residential						
Investor						
Other1	1	155	153	1	155	153
Owner occupied						
HAMP2	-	-	-	1	102	74
Deferral3	-	-	-	2	344	226
Revolving and junior liens						
Other1	1	62	59	3	222	218
	2	\$ 217	\$ 212	9	\$ 2,143	\$ 1,789

	TDR Modifications Three Months Ended September 30, 2013			TDR Modifications Nine Months Ended September 30, 2013		
	# of contracts	Pre-modification recorded investment	Post-modification recorded investment	# of contracts	Pre-modification recorded investment	Post-modification recorded investment
Troubled debt restructurings						
Real estate - commercial						
Deferral3	-	\$ -	\$ -	1	\$ 610	\$ 472

Real estate - residential						
Owner occupied						
Deferral <sup>3</sup>	-	-	-	1	137	137
Revolving and junior liens						
Other <sup>1</sup>	-	-	-	1	30	29
	-	\$ -	\$ -	3	\$ 777	\$ 638

1 Other: Change of terms from bankruptcy court

2 HAMP: Home Affordable Modification Program

3 Deferral: Refers to the deferral of principal

TDRs are classified as being in default on a case-by-case basis 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 and nine months ended September 30, 2014.

Troubled debt restructurings that Subsequently Defaulted	TDR Default Activity Three Months Ended September 30, 2013		TDR Default Activity Nine Months Ended September 30, 2013	
	# of contracts	Pre-modification outstanding recorded investment	# of contracts	Pre-modification outstanding recorded investment
Real estate - commercial				
Owner occupied special purpose	1	\$ 610	1	\$ 610
Real estate - residential				
Investor	-	-	1	155
Owner occupied	1	175	1	175
Revolving and junior liens	1	30	1	30
	3	\$ 815	4	\$ 970

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## 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 and nine months ended September 30, 2014, were as follows:

Allowance for loan losses:	Commercial	Real Estate Commercial 1	Real Estate Construction	Real Estate Residential	Consumer	Unallocated	Total
<b>Three months ended September 30, 2014</b>							
Beginning balance	\$ 1,991	\$ 13,228	\$ 1,754	\$ 2,373	\$ 1,464	\$ 3,046	\$ 23,856
Charge-offs	512	545	1	925	174	-	2,157
Recoveries	6	878	3	646	98	-	1,631
Provision (release)	41	(744)	141	7	16	539	-
Ending balance	\$ 1,526	\$ 12,817	\$ 1,897	\$ 2,101	\$ 1,404	\$ 3,585	\$ 23,330
<b>Nine months ended September 30, 2014</b>							
Beginning balance	\$ 2,250	\$ 16,763	\$ 1,980	\$ 2,837	\$ 1,439	\$ 2,012	\$ 27,281
Charge-offs	519	1,634	174	2,752	423	-	5,502
Recoveries	56	1,106	507	1,585	297	-	3,551
(Release) provision	(261)	(3,418)	(416)	431	91	1,573	(2,000)
Ending balance	\$ 1,526	\$ 12,817	\$ 1,897	\$ 2,101	\$ 1,404	\$ 3,585	\$ 23,330
<b>Ending balance:</b>							
Individually evaluated for impairment	\$ -	\$ 167	\$ 107	\$ 267	\$ -	\$ -	\$ 541
<b>Ending balance:</b>							
Collectively evaluated for impairment	\$ 1,526	\$ 12,650	\$ 1,790	\$ 1,834	\$ 1,404	\$ 3,585	\$ 22,789
<b>Financing receivables:</b>							
Ending balance	\$ 114,990	\$ 600,649	\$ 41,936	\$ 365,602	\$ 3,142	\$ 14,563	\$ 1,140,882
<b>Ending balance:</b>							
Individually evaluated for impairment	\$ 1,645	\$ 19,515	\$ 2,585	\$ 17,041	\$ -	\$ -	\$ 40,786
<b>Ending balance:</b>							
Collectively evaluated for impairment	\$ 113,345	\$ 581,134	\$ 39,351	\$ 348,561	\$ 3,142	\$ 14,563	\$ 1,100,096

1 As of September 30, 2014, this segment consisted of performing loans that included a higher risk pool of loans rated as substandard that totaled \$7.1 million. The amount of general allocation that was estimated for that portion of these

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performing substandard rated loans was \$1.2 million at September 30, 2014.

Changes in the allowance for loan losses by segment of loans based on method of impairment for the three and nine months ended September 30, 2013, were as follows:

Allowance for loan losses:	Commercial	Real Estate Commercial	Real Estate Construction	Real Estate Residential	Consumer	Unallocated	Total
<b>Three Months Ended September 30, 2013</b>							
Beginning balance	\$ 3,332	\$ 18,097	\$ 2,690	\$ 5,021	\$ 1,372	\$ 4,530	\$ 35,042
Charge-offs	29	851	53	3,594	168	-	4,695
Recoveries	60	523	15	209	143	-	950
(Release) provision	(469)	(1,354)	(252)	1,352	162	(1,189)	(1,750)
Ending balance	\$ 2,894	\$ 16,415	\$ 2,400	\$ 2,988	\$ 1,509	\$ 3,341	\$ 29,547
<b>Nine Months Ended September 30, 2013</b>							
Beginning balance	\$ 4,517	\$ 20,100	\$ 3,837	\$ 4,535	\$ 1,178	\$ 4,430	\$ 38,597
Charge-offs	308	2,377	951	5,193	474	-	9,303
Recoveries	104	3,752	1,265	792	390	-	6,303
(Release) provision	(1,419)	(5,060)	(1,751)	2,854	415	(1,089)	(6,050)
Ending balance	\$ 2,894	\$ 16,415	\$ 2,400	\$ 2,988	\$ 1,509	\$ 3,341	\$ 29,547
<b>Ending balance:</b>							
Individually evaluated for impairment	\$ -	\$ 750	\$ 412	\$ 988	\$ -	\$ -	\$ 2,150
<b>Ending balance:</b>							
Collectively evaluated for impairment	\$ 2,894	\$ 15,665	\$ 1,988	\$ 2,000	\$ 1,509	\$ 3,341	\$ 27,397
<b>Financing receivables:</b>							
Ending balance	\$ 98,026	\$ 554,874	\$ 30,996	\$ 376,859	\$ 2,570	\$ 14,315	\$ 1,077,640
<b>Ending balance:</b>							
Individually evaluated for impairment	\$ 29	\$ 24,849	\$ 7,698	\$ 21,675	\$ -	\$ -	\$ 54,251
<b>Ending balance:</b>							
Collectively evaluated for impairment	\$ 97,997	\$ 530,025	\$ 23,298	\$ 355,184	\$ 2,570	\$ 14,315	\$ 1,023,389

1 As of September 30, 2013, this segment consisted of performing loans that included a higher risk pool of loans rated as substandard that totaled \$14.4 million. The amount of general allocation that was estimated for that portion of these performing substandard rated loans was \$2.7 million at September 30, 2013.

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## 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 September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Other real estate owned				
Balance at beginning of period	\$ 39,232	\$ 59,465	\$ 41,537	\$ 72,423
Property additions	4,277	3,015	13,620	14,196
Property improvements	506	10	637	60
Less:				
Property disposals, net of gains/losses	1,618	11,463	12,136	30,928
Period valuation adjustments	1,520	1,961	2,781	6,685
Balance at end of period	\$ 40,877	\$ 49,066	\$ 40,877	\$ 49,066

Activity in the valuation allowance was as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Balance at beginning of period	\$ 17,873	\$ 30,487	\$ 22,284	\$ 31,454
Provision for unrealized losses	1,520	1,961	2,781	6,537
Reductions taken on sales	(348)	(7,571)	(5,431)	(13,305)
Other adjustments	-	(290)	(589)	(99)
Balance at end of period	\$ 19,045	\$ 24,587	\$ 19,045	\$ 24,587

Expenses related to OREO, net of lease revenue includes:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Gain on sales, net	\$ (201)	\$ (608)	\$ (610)	\$ (1,175)

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Provision for unrealized losses	1,520	1,961	2,781	6,537
Operating expenses	884	1,500	3,132	4,555
Less:				
Lease revenue	196	309	638	974
	\$ 2,007	\$ 2,544	\$ 4,665	\$ 8,943

Note 6 – Deposits

Major classifications of deposits were as follows:

	September 30, 2014	December 31, 2013
Noninterest bearing demand	\$ 380,687	\$ 373,389
Savings	236,289	228,589
NOW accounts	315,665	297,852
Money market accounts	296,418	309,859
Certificates of deposit of less than \$100,000	256,452	288,345
Certificates of deposit of \$100,000 or more	171,244	184,094
	\$ 1,656,755	\$ 1,682,128

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## Note 7 – Borrowings

The following table is a summary of borrowings as of September 30, 2014, and December 31, 2013. Junior subordinated debentures are discussed in detail in Note 8:

	September 30, 2014	December 31, 2013
Securities sold under repurchase agreements	\$ 29,438	\$ 22,560
FHLBC advances	40,000	5,000
Junior subordinated debentures	58,378	58,378
Subordinated debt	45,000	45,000
Notes payable and other borrowings	500	500
	\$ 173,316	\$ 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 have a carrying amount of \$29.4 million at September 30, 2014, and \$22.6 million at December 31, 2013. The fair value of the pledged collateral was \$43.4 million and \$39.2 million at September 30, 2014 and December 31, 2013, respectively. At September 30, 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. 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 September 30, 2014, the Bank had taken an advance of \$40.0 million on the FHLBC stock valued at \$4.3 million, collateralized securities with a fair value of \$93.1 million and loans with a principal balance of \$52.4 million, which carry a combined collateral value of \$91.2 million. The Company has excess collateral of \$49.9 million available to secure 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 portion of the senior debt facility when it matured and was terminated. The Company had \$500,000 in principal outstanding in term debt and \$45.0 million in principal outstanding in subordinated debt at the end of both September 30, 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 balance 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 by the Company under the senior debt agreement. The senior debt agreement also contains certain customary representations and warranties, and financial covenants. At September 30, 2014, the Company was out of compliance with two of the financial covenants contained within the credit agreement. As of June 30, 2014, the Company reported being out of compliance on one of the financial covenants contained in the referenced 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 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 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 senior debt 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. Specifically, the covenants that were not met address the Bank's return on average assets and nonperforming assets as a percentage of the Bank's primary capital, when calculated per the debt agreement.

#### 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 of cumulative trust preferred securities were sold 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 Old Second Capital Trust I 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.

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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 is allowed to defer payments of interest for 20 quarterly periods without default or penalty, but such amounts continue to accrue. Also during a 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, which totaled \$19.7 million, 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. The Company paid \$1.1 million of interest due in the third quarter of 2014. 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 of Operations.

Note 9 – Equity Compensation Plans

There are stock-based awards outstanding under the Company's 2008 Equity Incentive Plan (the "2008 Plan") and the Company's 2014 Equity Incentive Plan (the "2014 Plan," and together with the 2008 Plan, the "Plans"). The 2014 Plan was approved at the 2014 annual meeting of stockholders. Following approval of the 2014 Plan, no further awards will be granted under the 2008 Plan or any other Company equity compensation plan. A maximum of 375,000 shares may be issued under the 2014 Plan. The Plan authorizes the granting of qualified stock options, non-qualified stock options, restricted stock, restricted stock units, and stock appreciation rights. Awards may be granted to selected directors and officers or employees under the 2014 Plan at the discretion of the Compensation Committee of the Company's Board of Directors. As of September 30, 2014, 210,500 shares remained available for issuance under the 2014 Plan.

Total compensation cost that has been charged for the plans was \$189,000 in the first nine months of 2014 and \$123,000 in the first nine months of 2013.

There were no stock options granted in the third quarter of 2014 or 2013. All stock options are granted for a term of ten years. There were no stock options exercised during the third quarter of 2014 or 2013. There is no unrecognized compensation cost related to unvested stock options as all stock options of the Company's common stock have vested.

A summary of stock option activity in the Plans for the nine months ending September 30, 2014, is as follows:

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (years)	Aggregate Intrinsic Value
Beginning outstanding	325,500	\$ 29.56		
Canceled	-	-		
Ending outstanding	325,500	\$ 29.56	1.8	\$ -
Exercisable at end of period	325,500	\$ 29.56	1.8	\$ -

Generally, restricted stock and restricted stock units granted under the Plans vest three years from the grant date, but the Compensation Committee of 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 2008 Plan will become fully vested upon a merger or change in control of the Company. Under the 2014 Plan, upon a change in control of the Company, if (i) the 2014 Plan is not an obligation of the successor entity following the change in control, or (ii) the 2014 Plan is an obligation of the successor entity following the change in control and the participant incurs an involuntary termination, then the stock options, stock appreciation rights, stock awards and cash incentive awards under the 2014 Plan will become fully exercisable and vested. Performance-based awards generally will vest based upon the level of achievement of the applicable performance measures through the change in control.

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The Company granted restricted stock under its equity compensation plans beginning in 2005 and it began granting restricted stock units in February 2009. Restricted stock awards under the Plans generally entitle holders to voting and dividend rights upon grant and are subject to forfeiture until certain restrictions have lapsed including employment for a specific period. Restricted stock units under the Plans are also subject to forfeiture until certain restrictions have lapsed including employment for a specific period, and generally entitle holders to receive dividend equivalents during the restricted period but do not entitle holders to voting rights until the restricted period ends and shares are transferred in connection with the units.

There were no restricted awards issued under the Plans during the third quarter of 2014 and 184,500 restricted awards issued during the nine months ending September 30, 2014. There were no restricted awards issued during the third quarter of 2013 and 155,500 restricted awards issued for the nine months ending September 30, 2013. Compensation expense is recognized over the vesting period of the restricted award based on the market value of the award on the issue date.

A summary of changes in the Company's unvested restricted awards for the nine months ending September 30, 2014, is as follows:

	September 30, 2014	
	Restricted Stock Shares and Units	Weighted Average Grant Date Fair Value
Nonvested at January 1	185,500	\$ 2.95
Granted	184,500	4.82
Vested	(25,000)	2.06
Forfeited	(20,000)	1.74
Nonvested at September 30	325,000	\$ 4.15

Total unrecognized compensation cost of restricted awards was \$1.0 million as of September 30, 2014, which is expected to be recognized over a weighted-average period of 2.48 years. Total unrecognized compensation cost of restricted awards was \$411,000 as of September 30, 2013, which was expected to be recognized over a weighted-average period of 2.46 years.

Note 10 – Earnings Per Share

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The earnings per share – both basic and diluted – are included below as of September 30 (in thousands except for share data):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
Basic earnings per share:				
Weighted-average common shares outstanding	29,442,508	13,885,884	23,905,205	13,947,606
Weighted-average common shares less stock based awards	29,442,508	13,870,884	23,902,403	13,895,136
Weighted-average common shares stock based awards	325,000	231,152	225,232	217,107
Net income from operations	\$ 2,924	\$ 72,924	\$ 7,147	\$ 81,872
Gain on preferred stock redemption	-	-	(1,348)	-
Preferred stock dividends and accretion, net of dividends waived	1,065	1,323	(1,448)	3,917
Net earnings available to common stockholders	1,859	71,601	9,943	77,955
Undistributed earnings	1,859	71,601	9,943	77,955
Basic earnings per share common undistributed earnings	0.06	5.08	0.41	5.52
Basic earnings per share	0.06	5.08	0.41	5.52
Diluted earnings per share:				
Weighted-average common shares outstanding	29,442,508	13,885,884	23,905,205	13,947,606
Dilutive effect of nonvested restricted awards <sup>1</sup>	325,000	216,152	222,430	164,637
Diluted average common shares outstanding	29,767,508	14,102,036	24,127,635	14,112,243
Net earnings available to common stockholders	\$ 1,859	\$ 71,601	\$ 9,943	\$ 77,955
Diluted earnings per share	\$ 0.06	\$ 5.08	\$ 0.41	\$ 5.52

Number of antidilutive options excluded from the diluted earnings per share calculation

	1,140,839	1,224,839	1,140,839	1,224,839
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<sup>1</sup> Includes the common stock equivalents for restricted share rights that are dilutive.

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The above earnings per share calculation did not include a warrant for 815,339 shares of common stock that was outstanding as of September 30, 2014, and September 30, 2013 because the warrant was anti-dilutive. Of note, the warrant was sold at auction by the Treasury in June 2013 to a third party investor.

The Company completed the redemption of 25,669 shares of its Series B Stock in the second quarter of 2014. As previously disclosed, the Company completed a public offering of 15,525,000 shares of common stock in April of 2014. Net proceeds of over \$64.0 million were used to pay the accrued but unpaid interest on the Company's trust preferred securities or junior subordinated debentures discussed in Note 8, the accumulated but unpaid dividends on the Series B Stock and to complete this redemption. The amount remaining after the completion of these transactions was retained at the Company for use in addressing general corporate matters. The redemption price for such Series B Stock was 94.75% of the liquidation value of the Series B Stock provided that the holders of shares entered into agreements to forebear payment of dividends due and to waive any rights to such dividend upon redemption. The Company redeemed all shares of Series B Stock held by directors of the Company on the same terms.

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 September 30, 2014, the Bank's Tier 1 capital leverage ratio was 11.67%, up 70 basis points from December 31, 2013, and well above the 8.00% objective. The Bank's total capital ratio was 18.47%, up 43 basis points from December 31, 2013, and also well above the objective of 12.00%.

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 capital guidelines implemented by the Board of Governors of the Federal Reserve System. 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 September 30, 2014, and December 31, 2013. The Company's total risk-based capital ratio has been adjusted to correctly account for the Company's subordinated debt, a portion of which was excluded from Tier 2 capital because the subordinated debt is within five years of maturity. This change has also been made in all relevant prior quarters and has resulted in an immaterial reduction in the Company's total risk-based capital ratio for those periods. The reduction in regulatory capital amounts and ratios has no impact on the Company's historical consolidated financial statements or stockholders' equity, which were stated in accordance with GAAP.

The Company completed the redemption of certain of its Series B Fixed Rate Cumulative Preferred Stock (the "Series B Stock") in the second quarter, 2014. The Company completed a public offering of common stock in April. Net proceeds of over \$64.0 million were used to pay the accrued but unpaid interest on trust preferred securities, the accumulated but unpaid dividends on the Series B Stock and to complete this redemption. All ratios for September 30, 2014 reflect these changes in the Company's capital.

At September 30, 2014, the Company, on a consolidated basis, exceeded the minimum thresholds to be considered "adequately capitalized" under current regulatory defined capital ratios. The Company and the Bank are subject to regulatory capital requirements administered by federal banking agencies.

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Capital levels and industry defined regulatory minimum required levels:

	Actual Amount	Ratio	Minimum Required for Capital Adequacy Purposes		Minimum Required to be Well Capitalized 1	
			Amount	Ratio	Amount	Ratio
September 30, 2014						
Total capital to risk weighted assets						
Consolidated	\$ 234,500	17.56 %	\$ 106,834	8.00 %	N/A	N/A
Old Second Bank	246,873	18.47	106,929	8.00	\$ 133,662	10.00 %
Tier 1 capital to risk weighted assets						
Consolidated	190,724	14.28	53,424	4.00	N/A	N/A
Old Second Bank	230,087	17.22	53,446	4.00	80,170	6.00
Tier 1 capital to average assets						
Consolidated	190,724	9.68	78,812	4.00	N/A	N/A
Old Second Bank	230,087	11.67	78,864	4.00	98,581	5.00
December 31, 2013						
Total capital to risk weighted assets						
Consolidated	\$ 191,139	15.16 %	\$ 100,865	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

1 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 qualifies at 60% and 80% of the original amount for Tier 2 regulatory capital at September 30, 2014 and December 31, 2013, respectively. 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 September 30, 2014 all \$56.6 million of the trust preferred proceeds qualified as Tier 1 regulatory capital. As of December 31, 2013, trust preferred proceeds of \$51.6 million qualified as 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 September 30, 2014, and December 31, 2013.



## 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. The Bank has the ability and the authority to pay dividends to the Company to pay debt and to meet preferred dividend requirements.

As discussed in Note 8, as of September 30, 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 common stock. In the second quarter of 2014, the Company terminated the deferral period and paid all accumulated and unpaid interest on the junior subordinated debentures which totaled \$19.7 million. The Company is currently paying interest as it comes due and \$1.1 million was paid in the third quarter of 2014.

Furthermore, as with the debentures discussed above, the Company is prohibited from paying dividends on its common stock unless it has fully paid all deferred 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.

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. Series B Stock dividends of \$10.3 million were paid on May 15, 2014. The Company is currently paying dividends as they come due and \$1.1 million paid was paid on August 15, 2014.

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On April 28, 2014, the Company redeemed 25,669 shares of the Series B Stock from certain holders, which included certain of the Company's directors, at a redemption 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 did not receive any part of the declared dividend on the Series B Stock. In May, the Company paid \$10.3 million in Series B Stock dividends. In the second quarter, the Company also recognized benefit from \$5.4 million in net income available to common stockholders reflecting both reversal of dividends previously accrued as well as dividends accumulated but not accrued by the Company and waived by holders upon redemption.

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

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 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 September 30, 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 and some of the actively traded real estate mortgage investment conduits and collateralized mortgage obligations 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 valuations of auction rate asset-backed securities are considered Level 3 valuations.
- During the third quarter of 2014, asset-backed collateralized loan obligations were acquired and priced using data from a pricing matrix support by our bond accounting service provider and are therefore considered Level 2 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.
- 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

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servicing income to derive the resultant value. The Company is able to compare the valuation model inputs, such as the discount 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.

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

The tables below present the balance of assets and liabilities at September 30, 2014, and December 31, 2013, respectively, measured by the Company at fair value on a recurring basis:

	September 30, 2014			Total
	Level 1	Level 2	Level 3	
Assets:				
Investment securities available-for-sale				
U.S. Treasury	\$ 1,532	\$ -	\$ -	\$ 1,532
U.S. government agencies	-	1,638	-	1,638
States and political subdivisions	-	13,754	125	13,879
Corporate Bonds	-	30,781	-	30,781
Collateralized mortgage obligations	-	28,417	-	28,417
Asset-backed securities	-	109,017	83,781	192,798
Collateralized loan obligations	-	93,198	-	93,198
Loans held-for-sale	-	3,422	-	3,422
Mortgage servicing rights	-	-	5,640	5,640
Other assets (Interest rate swap agreements net of swap credit valuation)	-	42	-	42
Other assets (Mortgage banking derivatives)	-	266	-	266
Total	\$ 1,532	\$ 280,535	\$ 89,546	\$ 371,613

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Liabilities:

Other liabilities (Interest rate swap agreements)	\$ -	\$ 42	\$ -	\$ 42
Total	\$ -	\$ 42	\$ -	\$ 42

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	December 31, 2013			Total
	Level 1	Level 2	Level 3	
<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>

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

	Nine months ended September 30, 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)	3,178	-	(761)	6
Included in other comprehensive income	(1,748)	-	-	-
Purchases, issuances, sales, and settlements				
Purchases	63,704	-	-	-
Issuances	-	-	594	-
Sales	(135,490)	-	-	-
<b>Ending balance September 30, 2014</b>	<b>\$ 83,781</b>	<b>\$ 125</b>	<b>\$ 5,640</b>	<b>\$ -</b>

	Nine months ended September 30, 2013				
	Securities available-for- sale		States and	Mortgage	Interest Rate
	Collateralized Debt	Asset-backed	Political	Servicing	Swap
	Obligations		Subdivisions	Rights	Valuation
Beginning balance January 1, 2013	\$ 9,957	\$ -	\$ 132	\$ 4,116	\$ (47)
Transfers into Level 3	-	-	-	-	-
Transfers out of Level 3	-	-	-	-	-
Total gains or losses					
Included in earnings (or changes in net assets)	178	485	-	81	34
Included in other comprehensive income	1,898	(1,487)	-	-	-
Purchases, issuances, sales, and settlements					
Purchases	-	168,753	-	-	-
Issuances	-	-	-	1,259	-
Settlements	(946)	-	-	-	-
Sales	-	(20,539)	-	-	-
Ending balance September 30, 2013	\$ 11,087	\$ 147,212	\$ 132	\$ 5,456	\$ (13)

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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 September 30, 2014:

Measured at fair value on a recurring basis:	Fair Value	Valuation Methodology	Unobservable Inputs	Range of Input	Weighted Average of Inputs
Mortgage Servicing rights	5,640	Discounted Cash Flow	Discount Rate	10.0-30.75%	10.3 %
			Prepayment Speed	3.97-77.99%	9.5 %
Asset-backed securities	83,781	Discounted Cash Flow with comparable transaction yields	Credit Risk Premium	0.8-1.2%	1.0 %
			Liquidity Discount	4.0-4.3%	4.2 %

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

Measured at fair value on a recurring basis:	Fair Value	Valuation Methodology	Unobservable Inputs	Range of Input	Weighted Average of Inputs
Mortgage Servicing rights	5,807	Discounted Cash Flow	Discount Rate	10.2%	10.2 %
			Prepayment Speed	9.7%	9.7 %
Interest Rate Swap Valuation	(6)	Management estimate of credit risk exposure	Probability of Default	5.0-20%	12.5 %
Asset-backed securities	154,137	Discounted Cash Flow with comparable transaction yields	Credit Risk Premium	1.1-1.5%	1.2 %
			Liquidity Discount	4.5-5.1%	4.9 %



The \$125,000 on the state and political subdivisions line at September 30, 2014 and December 31, 2013, under Level 3 represents a security from a small, local municipality. Given the small dollar amount and size of the municipality involved, this is categorized as Level 3 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:

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 at September 30, 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:

	September 30, 2014			Total
	Level 1	Level 2	Level 3	
Impaired loans <sup>1</sup>	\$ -	\$ -	\$ 957	\$ 957
Other real estate owned, net <sup>2</sup>	-	-	40,877	40,877
Total	\$ -	\$ -	\$ 41,834	\$ 41,834

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 \$1.5 million, with a valuation allowance of \$541,000, resulting in a decrease of specific allocations within the allowance for loan losses of \$1.9 million for the nine months ended months ending September 30, 2014.

2 OREO is measured at the lower of carrying or fair value less costs to sell, and had a net carrying amount of \$40.9 million, which is made up of the outstanding balance of \$61.7 million, net of a valuation allowance of \$19.0 million and participations of \$1.8 million, at September 30, 2014.

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	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.

2 OREO is measured at the lower of carrying or fair value less costs to sell, and 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.

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 exposure to credit loss 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 Bank also has interest rate derivative positions to assist with risk management that are not designated as hedging instruments. These derivative positions relate to transactions in which the Bank enters an interest rate swap with a client while at the same time entering into an offsetting 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 September 30, 2014. The Bank had \$3.1 million in investment securities pledged to support interest rate swap activity with three correspondent financial institutions at 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 September 30, 2014, the notional amount of non-hedging interest rate swaps was \$19.0 million with a weighted average maturity of 2.6 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 MBS 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.

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The following table presents derivatives not designated as hedging instruments as of September 30, 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	\$ 19,018	Other Assets	\$ 42	Other Liabilities	\$ 42
Commitments <sup>1</sup>	215,264	Other Assets	266	N/A	-
Forward contracts <sup>2</sup>	15,000	N/A	-	Other Liabilities	-
Total			\$ 308		\$ 42

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

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

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.

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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 September 30, 2014, and December 31, 2013.

The following table is a summary of letter of credit commitments (in thousands):

	September 30, 2014			December 31, 2013		
	Fixed	Variable	Total	Fixed	Variable	Total
Letters of credit:						
Borrower:						
Financial standby	\$ 55	\$ 4,432	\$ 4,487	\$ 10	\$ 3,886	\$ 3,896
Commercial standby	-	49	49	-	51	51
Performance standby	416	5,819	6,235	1,580	2,723	4,303
	471	10,300	10,771	1,590	6,660	8,250
Nonborrower:						
Performance standby	-	622	622	-	867	867
	-	622	622	-	867	867
Total letters of credit	\$ 471	\$ 10,922	\$ 11,393	\$ 1,590	\$ 7,527	\$ 9,117

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## Note 14 – Fair Values of Financial Instruments

The estimated fair values 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 values as the carrying value, FHLBC stock is carried at a Level 2 fair value since December 31, 2012. The Company had redemptions of \$1.2 million in the third quarter of 2014. These redemptions were the only redemptions processed by the Company in the first nine months 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:

	September 30, 2014				
	Carrying Amount	Fair Value	Level 1	Level 2	Level 3
Financial assets:					
Cash and due from banks	\$ 33,260	\$ 33,260	\$ 33,260	\$ -	\$ -
Interest bearing deposits with financial institutions	10,797	10,797	10,797	-	-
Securities available-for-sale	362,243	362,243	1,532	276,805	83,906
Securities held-to-maturity	263,040	264,343	-	264,343	-
FHLBC and Reserve Bank Stock	9,058	9,058	-	9,058	-
Bank-owned life insurance	56,438	56,438	-	56,438	-
Loans held for sale	3,422	3,422	-	3,422	-
Loans, net	1,117,552	1,119,781	-	-	1,119,781
Accrued interest receivable	4,931	4,931	-	4,931	-
Financial liabilities:					
Noninterest bearing deposits	\$ 380,687	\$ 380,687	\$ 380,687	\$ -	\$ -
Interest bearing deposits	1,276,068	1,275,036	-	1,275,036	-
Securities sold under repurchase agreements	29,438	29,438	-	29,438	-
Other short-term borrowings	40,000	40,000	-	40,000	-
Junior subordinated debentures	58,378	54,840	32,532	22,308	-

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Subordinated debenture	45,000	38,691	-	38,691	-
Note payable and other borrowings	500	414	-	414	-
Borrowing interest payable	73	73	-	73	-
Deposit interest payable	518	518	-	518	-

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	December 31, 2013				
	Carrying	Fair			
	Amount	Value	Level 1	Level 2	Level 3
Financial assets:					
Cash and due from banks	\$ 33,210	\$ 33,210	\$ 33,210	\$ -	\$ -
Interest bearing deposits with 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 Reserve Bank 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	-
Financial liabilities:					
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 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 – Series B Preferred Stock (“Series B Stock”)

The Series B Stock was issued 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 the warrant that was 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.

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, 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 failed to pay dividends for an aggregate of six quarters on the Series B Stock, whether or not consecutive, the holders would 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 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 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.

As a result of the completed 2013 auctions, the Company's Board elected to stop accruing the dividend on the Series B Stock in the first quarter of 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 likely be able to redeem the Series B Stock at a price less than the face amount of the Series B Stock plus accrued and unpaid dividends. While the Company did not fully accrue the dividend on the Series B Stock in the first quarter of 2013 and did not accrue for it in subsequent quarters, the Company continued to evaluate whether accruing dividends on the Series B Stock was appropriate. In the second quarter of 2014, the Company completed redemption of 25,669 shares of its Series B Stock at a price equal to 94.75% of liquidation value provided that the holders of shares entered into agreements to forebear payment of dividends due and to waive any rights to such dividends upon redemption. Following the redemption, the Company resumed accrual in the second quarter of 2014. The Company currently intends to declare and pay future dividends on these shares. On August 15, 2014 the Company paid \$1.1 million in dividends on the Series B Stock. Payments of \$24.3 million resulted in redemption of 25,669 shares of Series B Stock in the second quarter of 2014. At

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September 30, 2014, the Company carried \$47.3 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.

## Note 16 – Income Taxes

Income tax expense (benefit) for year to date September 30, 2014 and September 30, 2013 was as follows:

	September 30, 2014	September 30, 2013
Current federal	\$ (62)	\$ 129
Current state	(17)	35
Deferred federal	3,017	2,935
Deferred state	1,046	1,049
Change in valuation allowance	-	(74,145)
	\$ 3,984	\$ (69,997)

The following were the components of the deferred tax assets and liabilities as of September 30, 2014 and December 31, 2013:

	September 30, 2014	December 31, 2013
Allowance for loan losses	\$ 10,648	\$ 12,725
Deferred compensation	798	788
Amortization of core deposit	1,993	1,656
Goodwill amortization/impairment	14,042	15,252
Stock option expense	642	583
OREO write downs	8,901	10,041
Federal net operating loss (“NOL”) carryforward	27,882	28,023
State net operating loss (“NOL”) carryforward	11,768	11,847
Deferred tax credit	1,453	1,444
Other assets	983	1,166
Total deferred tax assets	79,110	83,525
Accumulated depreciation on premises and equipment	(834)	(1,035)
Accretion on securities	(31)	(8)
Mortgage servicing rights	(2,491)	(2,571)
State tax benefits	(6,667)	(6,994)
Other liabilities	(411)	(178)

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Total deferred tax liabilities	(10,434)	(10,786)
Net deferred tax asset before valuation allowance	68,676	72,739
Tax effect on net unrealized losses on securities	5,062	4,927
Valuation allowance	(2,363)	(2,363)
Net deferred tax asset	\$ 71,375	\$ 75,303

At September 30, 2014, the Company had a \$79.7 million federal net operating loss carryforward of which, \$24.4 million expires in 2030, \$31.4 million expires in 2031, \$8.6 million expires in 2032, and \$15.3 million expires in 2033. The Company had a \$123.9 million state net operating loss carryforward of which, \$28.2 million expires in 2021, and \$95.7 million expires in 2025. In addition, the Company had a \$1.5 million alternative minimum tax credit subject to indefinite carryforward.

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

	September 30, 2014	September 30, 2013
Allowance for loan losses	\$ 2,077	\$ 4,536
Deferred Compensation	(10)	(40)
Amortization of core-deposit	(337)	(519)
Stock option expense	(59)	177
OREO write-downs	1,140	5,560
Federal net operating loss carryforward	141	(5,634)
State net operating loss carryforward	79	(1,248)
Deferred tax credit	(9)	-
Depreciation	(201)	(117)
Net premiums and discounts on securities	23	(109)
Mortgage servicing rights	(80)	596
Goodwill amortization/impairment	1,210	1,151
State tax benefits	(327)	(333)
Change in valuation allowance	-	(74,145)
Other, net	416	(36)
Total deferred tax expense	\$ 4,063	\$ (70,161)

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

	September 30, 2014	September 30, 2013
Tax at statutory federal income tax rate	\$ 3,896	\$ 4,156
Nontaxable interest income, net of disallowed interest deduction	(182)	(183)
BOLI income	(360)	(553)
State income taxes, net of federal benefit	606	780
Change in valuation allowance	-	(74,145)
Deficiency from restricted stock	-	10
Other, net	24	(62)
Tax at effective tax rate	\$ 3,984	\$ (69,997)



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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 that 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 presents information concerning our financial condition as of September 30, 2014, as compared to December 31, 2013, and the results of operations for the three and nine months ended September 30, 2014 and 2013. This discussion and analysis is best 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 operates, economies continued to gain momentum at a lackluster pace. Management believes the national economic statistics indicate an improving economy. However, economies in the Company's markets created only low levels of loan demand. Commercial Real Estate in our market areas remains stabilized with only vacant land in the far western portions of our operating area showing signs of stress. Residential mortgage demand was steady in the quarter but has yet to return to levels seen in 2013. Management continues to focus on growing commercial business. In the third quarter, existing commercial customers continued to see modest growth and profit margin improvement.

The Company remains vigilant in analyzing loan portfolio quality and making decisions to charge-off loans. Management review of the loan portfolio concluded that the reserve for loan and lease loss was adequate and appropriate for losses estimable at September 30, 2014. No loan loss reserve release or provision was recorded in the quarter. This compared to a \$1.8 million loan loss reserve release for the third quarter of 2013 and a \$1.0 million loan loss reserve release in each prior quarter of 2014.

Net income before taxes of \$4.7 million in the third quarter of 2014 compares to \$2.9 million for the third quarter of 2013 and \$3.1 million in the second quarter of 2014. Last year's quarter included lower levels of net interest income and gains on securities sales as well as higher levels of compensation and OREO noninterest expense. When compared to the third quarter, the second quarter 2014 reflected a lower level of gains on securities sales and net interest income as well as a \$1.0 million loan loss reserve release offset by higher noninterest expenses.

On September 17, 2014, the Company announced that James L. Eccher will be appointed the Chief Executive Officer and President of the Company, effective as of January 1, 2015, and that William B. Skoglund will retire from the position of Chief Executive Officer and President of the Company on the same date. Mr. Eccher will remain the Chief Executive Officer and President of the Bank. Following his retirement, Mr. Skoglund will remain the Chairman of the Board of both the Company and the Bank.

On September 16, 2014, the Company entered into an Employment Agreement (the "Agreement") with Mr. Eccher. Pursuant to the terms of the Agreement, Mr. Eccher will serve as Chief Executive Officer and President of the Company for a term of two (2) years beginning January 1, 2015, which term shall automatically extend for one

additional year beginning on January 1, 2016 and each January 1 thereafter. Mr. Eccher will remain eligible for all other benefits currently available to him, including a monthly car allowance, reimbursement of country club dues, the Company's incentive plans and medical, dental, disability, group and executive life insurance.

#### Results of Operations

In the third quarter of 2014, earnings per share were \$0.06 per diluted share on net income available to common shareholders of \$1.9 million. Earnings per share for the second quarter of 2014 were \$0.26 per diluted share on \$7.5 million of net income to common stockholders. Absent the benefits from gain on redemption of the Series B Stock and the Series B Stock dividends that were waived by the holders of Series B Stock that was redeemed, the Company realized \$0.02 per diluted share in the second quarter. These results compare to \$0.15 per diluted share, on net income to common stockholders of \$2.2 million for the second quarter of 2013 and net income available to common stockholders of \$630,000 for the first quarter of 2014. All 2014 Series B Stock dividends incorporate an increase in the dividend rate from 5% to 9% in February of 2014.

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Third quarter net income before taxes increased by \$1.7 million from the third quarter of 2013 and \$1.6 million from the second quarter of 2014. The increase from the third quarter of 2013 was driven by sharply higher gains on securities sales (a loss item in 2013), improved debit card interchange income reflecting an improving trend seen over recent quarters, and lower noninterest expense, notably Other Real Estate Owned (“OREO”) expenses were down because of lower valuation expenses. The linked quarter increase reflects improved net interest income, markedly higher gains on securities sales (up \$936,000) and reduced noninterest expense as the core deposit intangible asset reached full amortization and compensation costs moderated.

Third quarter net income available to common stockholders was \$1.9 million compared to \$1.6 million, after excluding the \$70.0 million tax benefit mainly from the reversal of a valuation allowance related to deferred tax assets, in the third quarter of 2013. On a linked quarter basis, third quarter net income available to common stockholders is compared to \$673,000 in the second quarter of this year, upon excluding the second quarter \$6.8 million benefit from the Company's redemption of a large amount of Series B Stock.

Net Interest Income

Net interest and dividend income increased \$1.0 million from \$13.7 million for the quarter ended June 30, 2014, to \$14.7 million for the quarter ended September 30, 2014. Average earning assets for the third quarter of 2014 decreased \$16.5 million, or 0.9%, from a total of \$1.81 billion in the second quarter of 2014. Loan production and participations or purchases in 2014 drove third quarter average loans, including loans held for sale, to a linked quarter nominal improvement of \$16.2 million, reversing the trend of declining average loan volume seen in 2013. Average loan volume for the third quarter, including loans held for sale, increased \$48.2 million when compared to the third quarter of 2013.

Repeating comments from previous reports, 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 decreased total securities in the third quarter of 2014 to 30.8% of total assets down from 31.4% at the end of 2013.

The net interest margin (tax-equivalent basis), expressed as a percentage of average earning assets, increased slightly from 3.25% in the third quarter of 2013 to 3.26% in the third quarter of 2014. The average tax-equivalent yield on earning assets decreased from 3.99% in the third quarter of 2013 to 3.78% in the third quarter of 2014. For the same comparative period, the cost of funds on interest bearing liabilities decreased from 0.94% to 0.70% providing some offset to the decrease in earning asset yield.



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 retain 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 and nine-month periods ended September 30, 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 September 30, 2014 and 2013

(Dollar amounts in thousands - unaudited)

	2014 Average Balance	Interest	Rate	2013 Average Balance	Interest	Rate
Assets						
Interest bearing deposits	\$ 38,603	\$ 25	0.25 %	\$ 36,456	\$ 22	0.24 %
Securities:						
Taxable	600,386	3,586	2.39	605,546	3,113	2.06
Non-taxable (TE)	12,237	169	5.52	13,937	228	6.54
Total securities	612,623	3,755	2.45	619,483	3,341	2.16
Dividends from Reserve Bank and FHLBC stock	9,085	78	3.43	10,292	76	2.95
Loans and loans held-for-sale (1)	1,137,137	13,429	4.62	1,088,936	14,382	5.17
Total interest earning assets	1,797,448	17,287	3.78	1,755,167	17,821	3.99
Cash and due from banks	32,459	-	-	19,584	-	-
Allowance for loan losses	(24,492)	-	-	(34,197)	-	-
Other noninterest bearing assets	230,232	-	-	190,836	-	-
Total assets	\$ 2,035,647			\$ 1,931,390		
Liabilities and Stockholders' Equity						
NOW accounts	\$ 321,968	\$ 68	0.08 %	\$ 283,192	\$ 63	0.09 %
Money market accounts	299,846	70	0.09	311,213	104	0.13
Savings accounts	238,528	37	0.06	225,825	39	0.07
Time deposits	437,597	1,073	0.97	493,722	1,674	1.35
Interest bearing deposits	1,297,939	1,248	0.38	1,313,952	1,880	0.57
Securities sold under repurchase agreements	27,266	1	0.01	21,646	1	0.02
Other short-term borrowings	12,174	4	0.13	15,707	5	0.12
Junior subordinated debentures	58,378	1,072	7.35	58,378	1,336	9.15
Subordinated debt	45,000	199	1.73	45,000	209	1.82
Notes payable and other borrowings	500	4	3.13	500	4	3.13
Total interest bearing liabilities	1,441,257	2,528	0.70	1,455,183	3,435	0.94
Noninterest bearing deposits	389,246	-	-	366,889	-	-
Other liabilities	11,416	-	-	37,466	-	-
Stockholders' equity	193,728	-	-	71,852	-	-

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Total liabilities and stockholders' equity	\$ 2,035,647		\$ 1,931,390	
Net interest income (TE)		\$ 14,759		\$ 14,386
Net interest income (TE) to total earning assets			3.26 %	3.25 %
Interest bearing liabilities to earning assets	80.18	%	82.91	%

(1).Interest income from loans is shown on a TE basis as discussed below and includes fees of \$600,000 and \$793,000 for the third quarter of 2014 and 2013, respectively. Nonaccrual loans are included in the above-stated average balances.

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Table of ContentsANALYSIS OF AVERAGE BALANCES,  
TAX EQUIVALENT INTEREST AND RATES

Nine Months Ended September 30, 2014 and 2013

(Dollar amounts in thousands - unaudited)

	2014 Average Balance	Interest	Rate	2013 Average Balance	Interest	Rate
<b>Assets</b>						
Interest bearing deposits	\$ 30,958	\$ 60	0.26 %	\$ 49,676	\$ 91	0.24 %
<b>Securities:</b>						
Taxable	615,136	10,440	2.26	574,761	8,109	1.88
Non-taxable (TE)	18,114	579	4.26	14,912	679	6.07
Total securities	633,250	11,019	2.32	589,673	8,788	1.99
<b>Dividends from Reserve Bank and FHLBC stock</b>						
	9,886	232	3.13	10,742	228	2.83
Loans and loans held-for-sale (1)	1,121,600	39,521	4.65	1,116,964	43,327	5.12
Total interest earning assets	1,795,694	50,832	3.74	1,767,055	52,434	3.92
Cash and due from banks	33,071	-	-	24,110	-	-
Allowance for loan losses	(25,570)	-	-	(37,122)	-	-
Other noninterest bearing assets	233,127	-	-	196,298	-	-
Total assets	\$ 2,036,322			\$ 1,950,341		
<b>Liabilities and Stockholders' Equity</b>						
NOW accounts	\$ 311,701	\$ 197	0.08 %	\$ 290,691	\$ 192	0.09 %
Money market accounts	308,109	247	0.11	319,876	342	0.14
Savings accounts	238,480	118	0.07	226,193	121	0.07
Time deposits	454,406	3,604	1.06	498,846	5,327	1.43
Interest bearing deposits	1,312,696	4,166	0.42	1,335,606	5,982	0.60
<b>Securities sold under repurchase agreements</b>						
	25,687	2	0.01	22,206	2	0.01
Other short-term borrowings	8,352	8	0.13	20,000	24	0.16
Junior subordinated debentures	58,378	3,847	8.79	58,378	3,937	8.99
Subordinated debt	45,000	593	1.74	45,000	610	1.79
Notes payable and other borrowings	500	12	3.16	500	12	3.16
Total interest bearing liabilities	1,450,613	8,628	0.79	1,481,690	10,567	0.95
Noninterest bearing deposits	384,350	-	-	359,438	-	-
Other liabilities	22,927	-	-	35,432	-	-
Stockholders' equity	178,432	-	-	73,781	-	-
Total liabilities and stockholders' equity	\$ 2,036,322			\$ 1,950,341		

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Net interest income (TE)		\$ 42,204		\$ 41,867
Net interest income (TE) to total earning assets			3.14 %	3.17 %
Interest bearing liabilities to earning assets	80.78	%	83.85	%

1 Interest income from loans is shown on a TE basis as discussed below and includes fees of \$1.7 million and \$2.0 million for the first nine months of 2014 and 2013, respectively. Nonaccrual loans are included in the above stated average balances.

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As indicated previously, net interest income and net interest income to earning assets have been adjusted to a non-GAAP TE basis using a marginal rate of 35% to more appropriately compare returns on tax-exempt 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:

(in thousands)	Three Months Ended		Nine Months Ended			
	September 30,		September 30,			
	2014	2013	2014	2013		
Net Interest Margin						
Interest income (GAAP)	\$ 17,199	\$ 17,724	\$ 50,546	\$ 52,146		
Taxable-equivalent adjustment:						
Loans	29	17	83	50		
Securities	59	80	203	238		
Interest income - TE	17,287	17,821	50,832	52,434		
Interest expense (GAAP)	2,528	3,435	8,628	10,567		
Net interest income -TE	\$ 14,759	\$ 14,386	\$ 42,204	\$ 41,867		
Net interest income (GAAP)	\$ 14,671	\$ 14,289	\$ 41,918	\$ 41,579		
Average interest earning assets	\$ 1,797,448	\$ 1,755,167	\$ 1,795,694	\$ 1,767,055		
Net interest margin (GAAP)	3.24	% 3.23	% 3.12	% 3.15	%	%
Net interest margin - TE	3.26	% 3.25	% 3.14	% 3.17	%	%

## Asset Quality

The Company had no loan loss reserve release or provision in the third quarter of 2014. By comparison, the Company recognized a \$1.8 million reserve release in the third quarter of 2013 and a \$1.0 million reserve release in the second quarter of 2014. The provision for loan loss creates a reserve for probable and estimable losses inherent in the loan portfolio. On a quarterly basis, management estimates the amount required and records the appropriate provision or release to maintain an adequate reserve for all potential and estimated loan losses.

Nonperforming loans increased to \$32.3 million at September 30, 2014 from \$28.9 million at June 30, 2014. The increase is driven by a small number of specific relationships and does not reflect issues throughout the portfolio. Net charge-offs totaled \$526,000 in the third quarter of 2014 while net charge-offs totaled \$3.7 million for the third quarter of 2013. The distribution of the Company's remaining nonperforming loans is included in the following table.

(in thousands)	Nonperforming Loans as of			September 30, 2014 Dollar Change From	
	September 30, 2014	June 30, 2014	December 31, 2013	June 30, 2014	December 31, 2013
Real estate-construction	\$ 794	\$ 807	\$ 2,729	\$ (13)	\$ (1,935)
Real estate-residential:					
Investor	1,901	3,932	6,615	(2,031)	(4,714)
Owner occupied	7,312	5,535	6,190	1,777	1,122
Revolving and junior liens	2,340	2,199	3,209	141	(869)
Real estate-commercial, nonfarm	18,312	16,390	21,024	1,922	(2,712)
Real estate-commercial, farm	-	-	-	-	-
Commercial	1,645	56	27	1,589	1,618
Other	-	-	-	-	-
	\$ 32,304	\$ 28,919	\$ 39,794	\$ 3,385	\$ (7,490)

Nonperforming loans consist of nonaccrual loans, nonperforming restructured accruing loans and loans 90 days or greater past due. Remediation work continues in all segments. New migration to nonaccrual increased to \$11.7 million during the third quarter of 2014 compared to \$1.6 million in the second quarter of 2014 and \$1.5 million in the third quarter of 2013. For the first nine months of 2014 new migration to nonaccrual was \$18.2 million compared to \$17.4 million for the nine months ending 2013.

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Loan Charge-offs, net of recoveries (in thousands)	Three Months Ended		
	September 30, 2014	June 30, 2014	December 31, 2013
Real estate-construction			
Homebuilder	\$ -	\$ (130)	\$ -
Land	-	-	(1)
Commercial speculative	-	(226)	62
All other	(2)	(6)	1
Total real estate-construction	(2)	(362)	62
Real estate-residential			
Investor	59	(13)	547
Owner occupied	(108)	96	(15)
Revolving and junior liens	328	206	139
Total real estate-residential	279	289	671
Real estate-commercial, nonfarm			
Owner general purpose	237	182	-
Owner special purpose	49	347	(3)
Non-owner general purpose	(419)	145	(1,258)
Non-owner special purpose	255	-	-
Retail properties	(455)	(1)	296
Total real estate-commercial, nonfarm	(333)	673	(965)
Real estate-commercial, farm			
Commercial	506	(32)	(7)
Other	76	52	5
	\$ 526	\$ 620	\$ (234)

Charge-offs for the third quarter of 2014 were, in many instances, from previously established specific reserves on nonaccrual loans deemed uncollectible. Gross charge-offs for the third quarter of 2014 were \$2.2 million compared to \$4.7 million for the third quarter of 2013 reflecting our efforts to improve loan quality in better but still challenging markets. Recoveries were \$1.6 million and \$950,000 for the same time periods, respectively.

Classified loans as of

September 30, 2014  
Dollar Change From



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(in thousands)	September 30, 2014	September 30, 2014	December 31, 2013	June 30, 2014	December 31, 2013
Real estate-construction	\$ 4,298	\$ 4,330	\$ 3,024	\$ (32)	\$ 1,274
Real estate-residential:					
Investor	3,407	5,312	9,750	(1,905)	(6,343)
Owner occupied	7,797	5,841	7,699	1,956	98
Revolving and junior liens	3,675	3,097	3,971	578	(296)
Real estate-commercial, nonfarm	24,768	19,634	37,297	5,134	(12,529)
Real estate-commercial, farm	-	-	-	-	-
Commercial	4,251	312	481	3,939	3,770
Other	1	1	1	-	-
	\$ 48,197	\$ 38,527	\$ 62,223	\$ 9,670	\$ (14,026)

Classified loans include nonaccrual, performing troubled debt restructurings and all other loans considered substandard. Loans classified as substandard are inadequately protected by either 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. Management review of classified loans concluded that the September 30, 2014 total was driven by a small number of specific relationships and does not reflect issues throughout the portfolio.

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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 growth in both classified loans and OREO in the third quarter of 2014, this ratio increased to 35.15% at September 30, 2014 from 31.27% at June 30, 2014 and 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):

	Three Months Ended					
	September 30, 2014	June 30, 2014	December 31, 2013			
Allowance at beginning of quarter	\$ 23,856	\$ 25,476	\$ 29,547			
Charge-offs:						
Commercial	512	3	8			
Real estate - commercial	545	760	608			
Real estate - construction	1	105	63			
Real estate - residential	925	978	1,100			
Consumer and other loans	174	139	123			
Total charge-offs	2,157	1,985	1,902			
Recoveries:						
Commercial	6	35	15			
Real estate - commercial	878	87	1,573			
Real estate - construction	3	467	1			
Real estate - residential	646	689	429			
Consumer and other loans	98	87	118			
Total recoveries	1,631	1,365	2,136			
Net charge-offs (recoveries)	526	620	(234)			
Loan loss reserve release	-	(1,000)	(2,500)			
Allowance at end of period	\$ 23,330	\$ 23,856	\$ 27,281			
Average total loans (exclusive of loans held-for-sale)	1,133,379	1,118,089	1,072,320			
Net charge-offs to average loans	0.05	%	0.06	%	(0.02)	%
Allowance at period end to average loans	2.06	%	2.13	%	2.54	%
Ending balance: Individually evaluated for impairment	\$ 541	\$ 1,440	\$ 2,395			
Ending balance: Collectively evaluated for impairment	\$ 22,789	\$ 22,416	\$ 24,886			

The coverage ratio of the allowance for loan losses to nonperforming loans was 72.2% at September 30, 2014 down from 82.5% as of June 30, 2014 and improved from 68.6% as of December 31, 2013. Management updated the estimated specific allocations in the third quarter after receiving more recent appraisals of collateral or information on cash flow trends related to the impaired credits. This update resulted in a sharply lower amount required in the reserve for estimable losses on these credits at the end of the third quarter 2014 compared to year end 2013 as well as second quarter 2014. The estimated general risk allocation was also lower when compared to both June 30, 2014 and December 31, 2013. The third component of the Company's loan loss reserve analysis showed higher required reserves when compared to June 30, 2014, most notably in the pooled commercial real estate category. Management determined that the dollar amount of loans in this component was \$7.1 million or markedly higher at period end third quarter 2014 compared to \$3.2 million at June 30, 2014. The dollar amount in the pooled commercial real estate category at September 30, 2014 was sharply improved from year end 2013.

After a review of the adequacy of the loan loss reserve at September 30, 2014, management concluded that, for the third quarter of 2014 neither a loan loss provision or a loan loss reserve release were appropriate. 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 2.1% of total loans at September 30, 2014. In management's judgment, an adequate allowance for estimated losses has been established for inherent losses at September 30, 2014; however, there can be no assurance that actual losses will not exceed the estimated amounts in the future.

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## Other Real Estate Owned

OREO increased modestly to \$40.9 million at September 30, 2014, from \$39.2 million at June 30, 2014 and decreased modestly from \$41.5 million at December 31, 2013. Property additions and improvements exceeded property disposals and valuation adjustments to OREO in the three months ended September 30, 2014. Third quarter additions to OREO included the reclassification of the New Lenox branch property, which reflected management's third quarter decision to close the branch on October 24, 2014. The nine months ended September 30, 2014 saw property disposals and valuation adjustments, exceed property additions and improvements to OREO by a nominal amount. The quarterly property additions and improvements have been relatively consistent at \$4.7 million, \$4.8 million and \$4.8 million for the quarters ended March 31, 2014, June 30, 2014 and September 30, 2014, respectively. At the same time, property disposals slowed and valuation adjustments spiked for a combined reduction to OREO of \$3.1 million for the quarter ended September 30, 2014, compared to combined reductions of \$6.0 million and \$5.8 million for the quarters ended March 31, 2014 and June 30, 2014, respectively. All OREO improvements in 2014 relate to several multifamily properties that were otherwise in severe disrepair.

(in thousands)	Three Months Ended		
	September 30, 2014	June 30, 2014	December 31, 2013
Beginning balance	\$ 39,232	\$ 40,220	\$ 49,066
Property additions	4,277	4,655	4,998
Property improvements	506	131	13
Less:			
Property disposals	1,618	4,949	10,784
Period valuation adjustments	1,520	825	1,756
Other real estate owned	\$ 40,877	\$ 39,232	\$ 41,537

The OREO valuation reserve was \$19.0 million, which was 31.8% of gross OREO at September 30, 2014. The valuation reserve represented 33.4% and 34.9% of gross OREO at September 30, 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 estimated costs to sell; however, there can be no assurance that additional losses will not be incurred on disposal or upon 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)	September 30, 2014			June 30, 2014			December 31, 2013		
	Amount	% of Total		Amount	% of Total		Amount	% of Total	
Single family residence	\$ 3,424	9 %		\$ 3,485	9 %		\$ 4,658	11 %	
Lots (single family and commercial)	14,258	35 %		15,002	38 %		15,020	36 %	
Vacant land	2,595	6 %		2,595	7 %		3,135	8 %	
Multi-family	6,140	15 %		5,175	13 %		1,783	4 %	
Commercial property	14,460	35 %		12,975	33 %		16,941	41 %	
Total OREO properties	\$ 40,877	100 %		\$ 39,232	100 %		\$ 41,537	100 %	

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## Noninterest Income

(in thousands)	Three Months Ended			3rd Qtr 2014 Dollar Change From	
	3rd Qtr	2nd Qtr	3rd Qtr	2nd Qtr	3rd Qtr
	2014	2014	2013	2014	2013
Trust income	\$ 1,483	\$ 1,677	\$ 1,494	\$ (194)	\$ (11)
Service charges on deposits	1,838	1,796	1,904	42	(66)
Residential mortgage banking revenue	1,340	1,257	1,232	83	108
Securities (loss) gains, net	1,231	295	(7)	936	1,238
Increase in cash surrender value of bank-owned life insurance	304	366	419	(62)	(115)
Death benefit realized on bank-owned life insurance	-	-	6	-	(6)
Debit card interchange income	1,011	930	873	81	138
Other income	1,116	1,160	1,549	(44)	(433)
Total noninterest income	\$ 8,323	\$ 7,481	\$ 7,470	\$ 842	\$ 853

On a linked quarter as well as year over year basis, gains from securities sales drove improved noninterest income. Debit card interchange income also strengthened while residential mortgage banking revenue improved in a difficult market. On a year to date basis, residential mortgage banking revenue declined approximately 48.9%. Trust income declined from second quarter's level reflecting stronger than normal estate administration fees in second quarter that returned to normal quarterly results. Second quarter trust income also included nonrecurring tax preparation fees. Year to date noninterest income is down 19.0% from 2013 essentially across all categories with the large dollar and percentage declines found in residential mortgage banking revenue and securities gains.

## Noninterest Expense

3rd Qtr 2014

Three Months Ended

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(in thousands)	3rd Qtr 2014	2nd Qtr 2014	3rd Qtr 2013	Dollar Change From	
				2nd Qtr 2014	3rd Qtr 2013
Salaries	\$ 7,141	\$ 7,128	\$ 7,010	\$ 13	\$ 131
Bonus	475	592	903	(117)	(428)
Benefits and other	1,240	1,463	1,386	(223)	(146)
Total salaries and employee benefits	8,856	9,183	9,299	(327)	(443)
Occupancy expense, net	1,143	1,185	1,266	(42)	(123)
Furniture and equipment expense	989	984	1,026	5	(37)
FDIC insurance	649	627	987	22	(338)
General bank insurance	371	343	489	28	(118)
Amortization of core deposit intangible asset	154	511	524	(357)	(370)
Advertising expense	291	459	347	(168)	(56)
Debit card interchange expense	418	412	366	6	52
Legal fees	332	409	615	(77)	(283)
Other real estate owned expense, net	2,007	1,650	2,544	357	(537)
Other expense	3,134	3,289	3,119	(155)	15
Total noninterest expense	\$ 18,344	\$ 19,052	\$ 20,582	\$ (708)	\$ (2,238)

Noninterest expense decreased on a linked quarter basis primarily on reduced compensation costs, cessation of the core deposit amortization expense and reduced advertising with an offset in increased OREO expenses, net. The OREO expense increase included valuation expense greater than the improvements in net gains on OREO sales and other OREO expense reduction combined. Reduced compensation costs reflect lower bonus accrual and health care costs quarter to quarter. The core deposit intangible asset was fully amortized in July of 2014. Lower advertising expense resulted from reduced expense for online and print advertising of retail

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products. Expenses decreased in the third quarter of 2014 compared to the same period in 2013 in most categories, including total OREO expense, net. On a year to date basis, noninterest expense is down 12.9% from 2013. All expense information incorporates a year end 2013 Company decision to reclassify OREO revenues from noninterest income to noninterest expense.

## Income Taxes

The Company recorded a tax expense of \$1.7 million on \$4.7 million pre-tax income for the third quarter of 2014. For the nine months ended September 30, 2014, tax expense was composed of \$79,000 in current income tax benefit and \$4.1 million in deferred income tax expense.

There have been no significant changes in the Company's ability to utilize the deferred tax assets through September 30, 2014. As such, the Company has not changed the valuation reserve on the deferred tax assets in 2014.

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, that closed in the second quarter of 2014, the Company amended the Tax Benefits Plan on April 3, 2014, to allow two identified investors who were purchasers in the offering to purchase more than 5% of the Company's common stock.

## Financial Condition

Total assets increased \$29.1 million, or 1.5%, from December 31, 2013, to \$2.03 billion as of September 30, 2014. Loans increased by \$39.6 million, or 3.6%, 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 \$660,000, or 1.6% at September 30, 2014, compared to year end 2013. Available-for-sale securities decreased by \$9.9 million while held-to-maturity securities increased \$6.5 million in the nine months ended September 30, 2014.

The core deposit intangible asset related to the Heritage Bank acquisition in February 2008 was fully amortized as of September 30, 2014 with incurred expense of \$1.2 million for the nine months ended September 30, 2014. Management performed an annual review of the core deposit intangible assets as of November 30, 2013.





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## Loans

Total loans were \$1.14 billion as of September 30, 2014, an increase of \$39.6 million from \$1.10 billion as of December 31, 2013. The increase in loans reflects successful loan production work in the period after extensive work in previous periods to build a robust loan pipeline. In the first nine months of 2014, the Company was successful in adding commercial loans and continued to add real estate loans in commercial construction and real estate while experiencing reductions in residential real estate loan holdings. A noteworthy specific increase in the third quarter came from two large loans financing commercial real estate construction. Management views these financings as extensions of credit to highly rated clients with the properties to be constructed reflecting strong and well structured lease documents with excellent tenants. 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 continue to be reluctant in utilizing existing lines of credit. Challenging economic circumstances and an intensely competitive environment served to temper overall loan growth.

(in thousands)	Major Classification of Loans as of			September 30, 2014 Dollar Change From	
	September 30, 2014	June 30, 2014	December 31, 2013	June 30, 2014	December 31, 2013
Commercial	\$ 106,592	\$ 106,752	\$ 94,736	\$ (160)	\$ 11,856
Real estate - commercial	600,649	599,796	560,233	853	40,416
Real estate - construction	41,936	32,265	29,351	9,671	12,585
Real estate - residential	365,602	368,592	390,201	(2,990)	(24,599)
Consumer	3,142	3,064	2,760	78	382
Overdraft	1,198	381	628	817	570
Lease financing receivables	8,398	8,722	10,069	(324)	(1,671)
Other	12,757	12,700	12,793	57	(36)
	1,140,274	1,132,272	1,100,771	8,002	39,503
Net deferred loan costs	608	475	485	133	123
	\$ 1,140,882	\$ 1,132,747	\$ 1,101,256	\$ 8,135	\$ 39,626

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 economic headwinds that have been experienced nationwide. The uneven and occasionally adverse economic conditions continue to affect the Midwest region in particular and financial markets generally. 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 88.4% of the portfolio as of September 30, 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.



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## Securities

(in thousands)	Securities Portfolio As of			September 30, 2014 Dollar Change From	
	September 30, 2014	June 30, 2014	December 31, 2013	June 30, 2014	December 31, 2013
Securities available-for-sale, at fair value					
U.S. Treasury	\$ 1,532	\$ 1,538	\$ 1,544	\$ (6)	\$ (12)
U.S. government agencies	1,638	1,653	1,672	(15)	(34)
States and political subdivisions	13,879	15,753	16,794	(1,874)	(2,915)
Corporate bonds	30,781	31,350	15,102	(569)	15,679
Collateralized mortgage obligations	28,417	33,083	63,876	(4,666)	(35,459)
Asset-backed securities	192,798	246,437	273,203	(53,639)	(80,405)
Collateralized loan obligations	93,198	-	-	93,198	93,198
Total securities available-for-sale	\$ 362,243	\$ 329,814	\$ 372,191	\$ 32,429	\$ (9,948)
Securities held-to-maturity, at amortized cost					
U.S. government agency mortgage-backed	\$ 37,321	\$ 37,306	\$ 35,268	\$ 15	\$ 2,053
Collateralized mortgage obligations	225,719	227,377	221,303	(1,658)	4,416
Total securities held-to-maturity	\$ 263,040	\$ 264,683	\$ 256,571	\$ (1,643)	\$ 6,469
Total securities	\$ 625,283	\$ 594,497	\$ 628,762	\$ 30,786	\$ (3,479)

The total investment portfolio reached \$625.3 million at September 30, 2014. The Available-for-Sale (“AFS”) portfolio increased \$32.4 million during the third quarter to end at \$362.2 million. Collateralized loan obligations (“CLO”) totaling \$94.2 million were purchased early in the quarter. Asset-backed security (“ABS”) sales for the quarter were \$95.3 million, partially offset by purchases of \$42.4 million. Sales of ABS, some late in the second quarter, provided funding for the CLO purchases. The Company had no purchase or sale activity in the Held to Maturity portfolio in the third quarter.

Realized gains totaled \$1.2 million for the third quarter of 2014. Unrealized losses on the AFS portfolio before deferred taxes were \$5.2 million at September 30, 2014 an increase of \$3.5 million for the quarter.

The Company is holding investments by four issuers where each issuer holding exceeds 10% of stockholders’ equity. Company investment managers have assessed the quality of the issuers to confirm that underwriting standards meet expectation and requirements under the Investment Policy. All of the investments for these issuers are guaranteed by the U.S. Department of Education.

The Company’s Board of Directors, at their July 15, 2014, meeting approved changes to the Investment Policy to allow purchases of CLO for the investment portfolio. Policy guidelines dictate that securities purchased are Volcker Rule compliant, are rated “A-“ or higher, and meet other stringent credit assessments. Policy also limits aggregate holdings and maximum issuer amount as percentages of capital.

As shown above, the addition of CLO to the portfolio and related reductions in other portfolio holdings, were the major events in the Company's securities asset management both in the third quarter 2014 and the nine month period ended September 30, 2014. At September 30, 2014, the Company investment managers have assessed the quality of the issuers to confirm that underwriting standards meet expectation and the requirements under the Company's Investment Policy.

While the Company's total securities holdings were essentially unchanged in the first nine months of 2014, meaningful changes were made in the period as discussed above to reduce available-for-sale ABS supported by student loan assets largely guaranteed by the U.S. Department of Education while increasing CLO holdings. The Company added a minor holding in held-to-maturity securities.

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## Deposits and Borrowings

(in thousands)	Deposit Detail As of			September 30, 2014 Dollar Change From	
	September 30, 2014	June 30, 2014	December 31, 2013	June 30, 2014	December 31, 2013
Noninterest bearing	\$ 380,687	\$ 393,964	\$ 373,389	\$ (13,277)	\$ 7,298
Savings	236,289	238,167	228,589	(1,878)	7,700
NOW accounts	315,665	310,721	297,852	4,944	17,813
Money market accounts	296,418	304,766	309,859	(8,348)	(13,441)
Certificates of deposits:					
of less than \$100,000	256,452	274,971	288,345	(18,519)	(31,893)
of \$100,000 or more	171,244	178,235	184,094	(6,991)	(12,850)
	\$ 1,656,755	\$ 1,700,824	\$ 1,682,128	\$ (44,069)	\$ (25,373)

Total deposits decreased \$25.4 million, or 1.5%, during the nine month period ended September 30, 2014 to \$1.66 billion. During the same period, savings, NOW and money market deposit volume increased by \$12.1 million. Also during the period, certificates of deposit decreased by \$44.7 million while noninterest bearing demand increased \$7.3 million. As of June 30, 2014, we continue to be among market share leaders in our home counties of Kane and Kendall in Illinois..

Average balance for interest bearing deposits was \$1.31 billion for the first nine months of 2014. Average balance for noninterest bearing deposits was \$384.4 million in the same period. Similar to the trends discussed above, when compared to the first nine months of 2013, average balances in 2014 reflect lower interest bearing deposit volumes, driven by time deposits, but increased noninterest bearing deposits. Management believes that reductions in average time deposits reflect maturities of deposits from past higher rate environments.

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 portion of the senior debt facility when it matured and was terminated. The Company had \$500,000 in principal outstanding in term debt and \$45.0 million in principal outstanding in subordinated debt at the end of both September 30, 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.

The credit facility agreement contains usual and customary provisions regarding acceleration of the senior debt upon the occurrence of an event of default by the Company under the senior debt agreement. The senior debt agreement also contains certain customary representations and warranties, and financial covenants. At September 30, 2014, the Company was out of compliance with two of the financial covenants contained within the credit agreement. As of June 30, 2014, the Company reported being out of compliance on one of the financial covenants contained in the referenced 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 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 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 senior debt 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. Specifically, the covenants that were not met address the Bank's return on average assets and nonperforming assets as a percentage of the Bank's primary capital, when calculated per the debt agreement.

The Company increased its securities sold under repurchase agreements to \$29.4 million at September 30, 2014, from \$22.6 million at December 31, 2013. The Company had taken an advance of \$40.0 million at September 30, 2014 representing an increase when compared to \$5.0 million at December 31, 2013 and no outstanding advances at June 30, 2014.

The Company is also obligated 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. In April 2014, the Company concluded a successful capital raise and used some of the capital raise proceeds to pay interest accrued but previously unpaid on the trust preferred securities. The Company is currently paying interest as it comes due, and \$1.1 million was paid in the third quarter of 2014. The Company is current on all payments due on these securities.

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Capital

As of September 30, 2014, total stockholders' equity was \$192.7 million, which was an increase of \$45.0 million from \$147.7 million as of December 31, 2013. This increase was primarily attributable to the capital raise conducted in the second quarter of 2014 in which the Company issued 15,525,000 shares of common stock with net proceeds exceeding \$64.0 million. Subsequent to the offering, the Company used \$19.7 million to pay all outstanding interest on the junior subordinated debentures and repurchase 25,669 shares of Series B Stock. The Company repurchased the preferred shares for 94.75% of the liquidation value totaling payments of \$24.3 million. 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. Lastly, the Company used \$10.3 million to pay all accumulated and outstanding Series B Stock dividends. As part of the Series B Stock repurchase agreements, the holders of the Series B Stock agreed to forbear any rights to accumulated, unpaid dividends. The remaining proceeds from the capital raise are being held for general corporate purposes.

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. See Note 11 -Regulatory and Capital Matters for a complete discussion of all regulatory capital guidelines.

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 deferred 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 was not immediately paid by the indenture trustees to the holders of such trust preferred securities. Instead, the trustees held the interest payments in irrevocable deposit accounts to 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. In the third quarter of 2014, the Company paid \$1.1 million for the regularly scheduled payments.

During the fourth quarter 2012, the Treasury announced the continuation of individual auctions of the Series B Stock that was issued through 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 September 30, 2014, the Company carried \$72.9 million and \$47.3 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. The Company paid \$1.1 million on August 15, 2014 and is current with the Series B Stock dividends.

Management has all options to redeem the Series B Stock, which carries a 9.0% dividend rate, under evaluation. The Company will take action to redeem the Series B Stock only when it is effective to do so and after a complete review of long term and short term considerations.



Beginning January 1, 2015, the Company and the Bank will be subject to the new capital requirements of Basel III. The Basel III Rules not only increase selected minimum regulatory capital ratios, but also introduce a new Common Equity Tier 1 capital ratio and the concept of a capital conservation buffer. The rules revise the criteria that certain instruments must meet to qualify as Tier 1 or Tier 2 capital. The Basel III Rules permit smaller banking organizations to retain, through a one-time election, the existing treatment of accumulated other comprehensive income. Management is reviewing the new rules to assess their impact on the Company.

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The Company's non-GAAP tangible common equity to tangible assets and the Tier 1 common equity to risk weighted assets increased to 7.15% and 6.50%, respectively, at September 30, 2014, compared to 3.67% and 0.77%, respectively, at December 31, 2013. The issuance of 15,525,000 common shares net of repurchasing 25,669 Series B Stock resulted in a positive impact on the regulatory ratios and the non-GAAP ratios noted above in the quarter ending September 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.

(dollars in thousands)	(unaudited)		(unaudited)
	As of September 30,		As of
	2014	2013	December
			31,
			2013
Tier 1 capital			
Total equity	\$ 192,691	\$ 142,039	\$ 147,692
Tier 1 adjustments:			
Trust preferred securities allowed	56,625	51,491	51,577
Cumulative other comprehensive loss	7,232	12,435	7,038
Disallowed goodwill and intangible assets	-	(1,702)	(1,177)
Disallowed deferred tax assets	(65,260)	(71,588)	(70,350)
Other	(564)	(546)	(581)
Tier 1 capital	\$ 190,724	\$ 132,129	\$ 134,199
Total capital			
Tier 1 capital	\$ 190,724	\$ 132,129	\$ 134,199
Tier 2 additions:			
Allowable portion of allowance for loan losses	16,782	16,565	15,898
Additional trust preferred securities disallowed for tier 1 capital	-	5,134	5,048
Subordinated debt	27,000	36,000	36,000
Tier 2 additions subtotal	43,782	57,699	56,946
Allowable Tier 2	43,782	57,699	56,946
Other Tier 2 capital components	(6)	(6)	(6)
Total capital	\$ 234,500	\$ 189,822	\$ 191,139
Tangible common equity			
Total equity	\$ 192,691	\$ 142,039	\$ 147,692
Less: Preferred equity	47,331	72,667	72,942

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Goodwill and intangible assets	-	1,702	1,177
Tangible common equity	\$ 145,360	\$ 67,670	\$ 73,573
Tier 1 common equity			
Tangible common equity	\$ 145,360	\$ 67,670	\$ 73,573
Tier 1 adjustments:			
Cumulative other comprehensive loss	7,232	12,435	7,038
Other	(65,824)	(72,134)	(70,931)
Tier 1 common equity	\$ 86,768	\$ 7,971	\$ 9,680
Tangible assets			
Total assets	\$ 2,033,099	\$ 2,032,788	\$ 2,004,034
Less:			
Goodwill and intangible assets	-	1,702	1,177
Tangible assets	\$ 2,033,099	\$ 2,031,086	\$ 2,002,857
Total risk-weighted assets			
On balance sheet	\$ 1,300,773	\$ 1,274,628	\$ 1,224,438
Off balance sheet	34,883	37,555	36,023
Total risk-weighted assets	\$ 1,335,656	\$ 1,312,183	\$ 1,260,461
Average assets			
Total average assets for leverage	\$ 1,969,823	\$ 1,857,554	\$ 1,927,217

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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 customers' 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 \$14.4 million during the first nine months of 2014, compared with net cash inflows of \$19.7 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 nine months of 2014 and 2013. Interest paid, net of interest received, combined with changes in other assets and liabilities were a source of outflows for the first nine months of 2014 compared to inflows in the first nine months of 2013. The majority of this outflow was the payment of the accumulated and unpaid interest to the trust preferred securities totaling \$20.8 million. 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 \$34.4 million in the first nine months of 2014, compared to net cash inflows of \$18.4 million in the same period in 2013. In the first nine months of 2014, securities transactions accounted for net inflows of \$7.2 million, and net principal disbursed on loans accounted for net outflows of \$53.0 million. In the first nine months of 2013, securities transactions accounted for net outflows of \$62.0 million, and net principal received on loans accounted for net inflows of \$49.9 million. Proceeds from sales of OREO accounted for \$12.7 million and \$32.1 million in investing cash inflows for the first nine months of 2014 and 2013, respectively.

Net cash inflows from financing activities in the first nine months of 2014 were \$45.2 million, compared with net cash outflows of \$86.5 million in the first nine months of 2013. Proceeds from the issuance of common stock provided net cash inflows of \$64.4 million, while the redemption of Series B Stock and dividends paid on Series B Stock accounted for net cash outflows of \$24.3 million and \$11.3 million, respectively, in the first nine months of 2014. Net deposit outflows in the first nine months of 2014 were \$25.4 million compared to net deposit outflows of \$44.1 million in the first nine months of 2013. Other short-term borrowings had net cash inflows of \$35.0 million and outflows of \$45.0 million related to FHLBC advance in the first nine months of 2014 and repayment in the first nine months of 2013. Changes in securities sold under repurchase agreements accounted for \$6.9 million and \$2.8 million in net inflows, respectively, in the first nine months 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.

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, it is not exposed to significant market risk from trading activities. The Company's interest rate risk exposures from September 30, 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, 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

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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 have 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 nine months 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 nine months of 2014 made that calculation possible as of September 30, 2014, which is reflected in the table.

## Analysis of Net Interest Income Sensitivity

	Immediate Changes in Rates						
	(2.0) %	(1.0) %	(0.5) %	0.5 %	1.0 %	2.0 %	
September 30, 2014							
Dollar change	N/A	N/A	\$ (275)	\$ (443)	\$ (198)	\$ 479	
Percent change	N/A %	N/A %	(0.5) %	(0.8) %	(0.3) %	0.8 %	
December 31, 2013							
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 September 30, 2014. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that as of September 30, 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.

There were no changes in the Company's internal control over financial reporting during the quarter ended September 30, 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," "may," "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

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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:

- 10.1 Employment Agreement, dated September 16, 2014, by and among Old Second Bancorp, Inc. and James Eccher (filed as Exhibit 10.1 to the Company's Form 8-K filed on September 18, 2014 and incorporated herein by reference).
- 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 September 30, 2014, and December 31, 2013; (ii) Consolidated Statements of Operations for the three and nine months ended September 30, 2014, and September 30, 2013; (iii) Consolidated Statements of Stockholders' Equity for the nine months ended September 30, 2014, and September 30, 2013; (iv) Consolidated Statements of Cash Flows for the nine months ended September 30, 2014, and September 30, 2013; and (v) Notes to Consolidated Financial Statements, tagged as blocks of text and in detail.\*

\* 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 and 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~~ William B.  
Skoglund  
William B.  
Skoglund

Chairman of the  
Board, Director  
President and  
Chief Executive  
Officer  
(principal  
executive officer)

~~BY~~ J. Douglas  
Cheatham  
J. Douglas  
Cheatham

Executive  
Vice-President and  
Chief Financial  
Officer, Director  
(principal financial  
and accounting  
officer)

DATE: November 12, 2014

