

OLD SECOND BANCORP INC
Form 10-K
March 11, 2016
Table of Contents

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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-K

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

For the fiscal year ended December 31, 2015

OR

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

For the transition period from to

Commission file number 0-10537

Delaware 36-3143493
(State of Incorporation) (IRS Employer Identification Number)

37 South River Street, Aurora, Illinois 60507

(Address of principal executive offices, including zip code)

(630) 892-0202

(Registrant's telephone number, including Area Code)

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Securities registered pursuant to Section 12(b) of the Act:

Title of Class	Name of each exchange on which registered
Common Stock, \$1.00 par value	The Nasdaq Stock Market
Preferred Securities of Old Second Capital Trust I	The Nasdaq Stock Market

Securities registered pursuant to Section 12(g) of the Act:

Preferred Share Purchase Rights

(Title of Class)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes
No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act.

Yes
No

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days.

Yes
No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Website, 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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by Reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

Large accelerated filer	Accelerated filer
Non-accelerated filer (Do not check if 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

The aggregate market value of the voting and non-voting common equity held by non-affiliates of the registrant, on June 30, 2015, the last business day of the registrant's most recently completed second fiscal quarter, was approximately \$187.2 million. The number of shares outstanding of the registrant's common stock, par value \$1.00 per share, was 29,483,429 at March 8, 2016.

Table of Contents

OLD SECOND BANCORP, INC.

Form 10-K

INDEX

PART I

Item 1	<u>Business</u>	3
Item 1A	<u>Risk Factors</u>	19
Item 1B	<u>Unresolved Staff Comments</u>	26
Item 2	<u>Properties</u>	26
Item 3	<u>Legal Proceedings</u>	26
Item 4	<u>Mine Safety Disclosures</u>	26

PART II

Item 5	<u>Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities</u>	27
Item 6	<u>Selected Financial Data</u>	29
Item 7	<u>Management's Discussion and Analysis of Financial Condition and Results of Income</u>	29
Item 7A	<u>Quantitative and Qualitative Disclosures about Market Risk</u>	43
Item 8	<u>Financial Statements and Supplementary Data</u>	45
Item 9	<u>Changes in and Disagreements with Accountants on Accounting and Financial Disclosure</u>	85
Item 9A	<u>Controls and Procedures</u>	85
Item 9B	<u>Other Information</u>	87

PART III

Item 10	<u>Directors, Executive Officers, and Corporate Governance</u>	87
Item 11	<u>Executive Compensation</u>	87
Item 12		87

Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

Item 13	<u>Certain Relationships and Related Transactions, and Director Independence</u>	88
Item 14	<u>Principal Accountant Fees and Services</u>	88
PART IV		
Item 15	<u>Exhibits and Financial Statement Schedules</u>	88
	<u>Signatures</u>	89

Table of Contents

Item 1. Business

General

Old Second Bancorp, Inc. (the "Company" or the "Registrant") was organized under the laws of Delaware on September 8, 1981. It is a registered bank holding company under the Bank Holding Company Act of 1956 (the "BHCA"). The Company's office is located at 37 South River Street, Aurora, Illinois 60507.

The Company conducts a full service community banking and trust business through the following wholly owned subsidiaries, which together with the Registrant are referred to as the "Company":

- Old Second National Bank (the "Bank").
- Old Second Capital Trust I, which was formed for the exclusive purpose of issuing trust preferred securities in an offering that was completed in July 2003.
- Old Second Capital Trust II, which was formed for the exclusive purpose of issuing trust preferred securities in an offering that was completed in April 2007.
- Old Second Affordable Housing Fund, L.L.C., which was formed for the purpose of providing down payment assistance for home ownership to qualified individuals.
- A series of limited liability companies wholly owned by the Bank and formed between 2008 and 2012 to hold property acquired by the Bank through foreclosure or in the ordinary course of collecting a debt previously contracted with borrowers.
- River Street Advisors, LLC, a wholly owned subsidiary of the Bank, which was formed in May 2010 to provide investment advisory/management services.

Inter-company transactions and balances are eliminated in consolidation.

The Company provides financial services through its 24 banking locations that are located primarily in Aurora, Illinois, and its surrounding communities and throughout the Chicago metropolitan area. These locations included retail offices located in Kane, Kendall, DeKalb, DuPage, LaSalle, Will and Cook counties in Illinois as of December 31, 2015.

Business of the Company and its Subsidiaries

The Bank's full service banking businesses include the customary consumer and commercial products and services that banking institutions provide including demand, NOW, money market, savings, time deposit, individual retirement and Keogh deposit accounts; commercial, industrial, consumer and real estate lending, including installment loans, student loans, agricultural loans, lines of credit and overdraft checking; safe deposit operations; trust services; wealth management services; and an extensive variety of additional services tailored to the needs of individual customers, such as the acquisition of U.S. Treasury notes and bonds, the sale of traveler's checks, money orders, cashiers' checks and foreign currency, direct deposit, discount brokerage, debit cards, credit cards, and other special services. The Bank also offers a full complement of electronic banking services such as online and mobile banking and corporate cash management products including remote deposit capture, mobile deposit capture, investment sweep accounts, zero balance accounts, automated tax payments, ATM access, telephone banking, lockbox accounts, automated clearing house transactions, account reconciliation, controlled disbursement, detail and general information reporting, wire transfers, vault services for currency and coin, and checking accounts. Commercial and consumer loans are made to corporations, partnerships and individuals, primarily on a secured basis. Commercial lending focuses on business, capital, construction, inventory and real estate lending. Installment lending includes direct and indirect loans to consumers and commercial customers. Additionally, the Bank provides a wide range of wealth management, investment, agency, and custodial services for individual, corporate, and not-for-profit clients. These services include the administration of estates and personal trusts, as well as the management of investment accounts for individuals, employee benefit plans, and charitable foundations. The Bank also originates residential mortgages, offering a wide range of mortgage products including conventional, government, and jumbo loans. Secondary marketing of those mortgages is also handled at the Bank.

Operating segments are components of a business about which separate financial information is available and that are evaluated regularly by the Company's management in deciding how to allocate resources and assess performance. Public companies are required to report certain financial information about operating segments. The Company's management evaluates the operations of the Company as one operating segment, i.e. community banking.

Market Area

The Company's primary market area is Aurora, Illinois and its surrounding communities. The city of Aurora is located in northeastern Illinois, approximately 40 miles west of Chicago. The Bank operates primarily in Kane, Kendall, DeKalb, DuPage, LaSalle, Will and Cook counties in Illinois, and it has developed a strong presence in these counties. The Bank offers its services to retail, commercial, industrial, and public entity customers in the Aurora, North Aurora, Batavia, St. Charles, Burlington, Elburn, Elgin, Maple Park,

Table of Contents

Kaneville, Sugar Grove, Naperville, Lisle, Joliet, Yorkville, Plano, Wasco, Ottawa, Oswego, Sycamore, Frankfort, and Chicago Heights communities and surrounding areas. During 2015 the Company closed one of two branches in Batavia.

Lending Activities

The Bank provides a broad range of commercial and retail lending services to corporations, partnerships, individuals and government agencies. The Bank actively markets its services to qualified borrowers. Lending officers actively solicit the business of new borrowers entering our market areas as well as long-standing members of the local business community. The Bank has established lending policies that include a number of underwriting factors to be considered in making a loan, including location, amortization, loan to value ratio, cash flow, pricing, documentation and the credit history of the borrower. In 2015, the Bank originated approximately \$430.8 million in loans. Also in 2015, residential mortgage loans of approximately \$190.6 million (some of which were originated in 2014) were sold to third parties. The Bank's loan portfolios are comprised primarily of loans in the areas of commercial real estate, residential real estate, construction, general commercial and consumer lending. As of December 31, 2015, residential mortgages made up approximately 31% (32% at year-end 2014) of the Bank's loan portfolio, commercial real estate loans comprised approximately 53% (52% at year-end 2014), construction lending comprised approximately 2%, general commercial loans comprised approximately 12% (10% at year-end 2014), and consumer and other lending comprised less than 2%. It is the Bank's policy to comply at all times with the various consumer protection laws and regulations including, but not limited to, the Equal Credit Opportunity Act, the Fair Housing Act, the Community Reinvestment Act, the Truth in Lending Act, and the Home Mortgage Disclosure Act.

Commercial Loans. The Bank continues to focus on growing commercial and industrial prospects in its new business pipeline with positive results in 2015. As noted above, the Bank is an active commercial lender, primarily located west and south of the Chicago metropolitan area and active in other parts of the Chicago and Aurora metropolitan areas. Commercial lending reflects revolving lines of credit for working capital, lending for capital expenditures on manufacturing equipment and lending to small business manufacturers, service companies, medical and dental entities as well as specialty contractors. The Bank also has commercial and industrial loans to customers in food product manufacturing, food process and packing, machinery tooling manufacturing as well as service and technology companies. Collateral for these loans generally includes accounts receivable, inventory, equipment and real estate. In addition, the Bank may take personal guarantees to help assure repayment. Loans may be made on an unsecured basis if warranted by the overall financial condition of the borrower. Commercial term loans range principally from one to eight years with the majority falling in the one to five year range. Interest rates are primarily fixed although some have interest rates tied to the prime rate or LIBOR. In 2015, the Bank closed a meaningful amount of fixed rate loans with terms longer than four years. While management would like to continue to diversify the loan portfolio, overall demand for working capital and equipment financing continued to be muted in the Bank's primary market area in 2015.

Repayment of commercial loans is largely dependent upon the cash flows generated by the operations of the commercial enterprise. The Bank's underwriting procedures identify the sources of those cash flows and seek to match the repayment terms of the commercial loans to the sources. Secondary repayment sources are typically found in

collateralization and guarantor support.

Commercial Real Estate Loans. While management has been actively working to reduce the Bank's concentration in real estate loans, including commercial real estate loans, a large portion of the loan portfolio continues to be comprised of commercial real estate loans. As of December 31, 2015, approximately \$297.5 million, or 49.1% (50.3%, at year-end 2014) of the total commercial real estate loan portfolio of \$605.7 million was to borrowers who secured the loan with owner occupied property. A primary repayment risk for a commercial real estate loan is interruption or discontinuance of cash flows from operations. Such cash flows are usually derived from rent in the case of nonowner occupied commercial properties. Repayment could also be influenced by economic events, which may or may not be under the control of the borrower, or changes in regulations that negatively impact the future cash flow and market values of the affected properties. Repayment risk can also arise from general downward shifts in the valuations of classes of properties over a given geographic area such as the ongoing but diminished price adjustments that have been observed by the Company beginning in 2008. Property valuations could continue to be affected by changes in demand and other economic factors, which could further influence cash flows associated with the borrower and/or the property. The Bank attempts to mitigate these risks by staying apprised of market conditions and by maintaining underwriting practices that provide for adequate cash flow margins and multiple repayment sources as well as remaining in regular contact with its borrowers. In most cases, the Bank has collateralized these loans and/or has taken personal guarantees to help assure repayment. Commercial real estate loans are primarily made based on the identified cash flow of the borrower and/or the property at origination and secondarily on the underlying real estate acting as collateral. Additional credit support is provided by the borrower for most of these loans and the probability of repayment is based on the liquidation value of the real estate and enforceability of personal and corporate guarantees if any exist.

Construction Loans. The Bank's construction and development lending and related risks have greatly diminished from prior periods as the construction and development portfolio no longer dominates the Bank's commercial real estate portfolio. Loans in this category decreased from \$44.8 million at December 31, 2014, to \$19.8 million at December 31, 2015. The Bank uses underwriting and construction loan guidelines to determine whether to issue loans on build-to-suit or build out of existing borrower properties.

Construction loans are structured most often to be converted to permanent loans at the end of the construction phase or, infrequently, to be paid off upon receiving financing from another financial institution. Construction loans are generally limited to our local market area. Lending decisions have been based on the appraised value of the property as determined by an independent appraiser, an analysis

Table of Contents

of the potential marketability and profitability of the project and identification of a cash flow source to service the permanent loan or verification of a refinancing source. Construction loans generally have terms of up to 12 months, with extensions as needed. The Bank disburses loan proceeds in increments as construction progresses and as inspections warrant.

Construction loans involve additional risks. Development lending often involves the disbursement of substantial funds with repayment dependent, in part, on the success of the ultimate project rather than the ability of the borrower or guarantor to repay principal and interest. This generally involves more risk than other lending because it is based on future estimates of value and economic circumstances. While appraisals are required prior to funding, and loan advances are limited to the value determined by the appraisal, there is the possibility of an unforeseen event affecting the value and/or costs of the project. Development loans are primarily used for single-family developments, where the sale of lots and houses are tied to customer preferences and interest rates. If the borrower defaults prior to completion of the project, the Bank may be required to fund additional amounts so that another developer can complete the project. The Bank is located in an area where a large amount of development activity has occurred as rural and semi-rural areas are being suburbanized. This type of growth presents some economic risks should local demand for housing shift. The Bank addresses these risks by closely monitoring local real estate activity, adhering to proper underwriting procedures, closely monitoring construction projects, and limiting the amount of construction development lending.

Residential Real Estate Loans. Residential first mortgage loans, second mortgages, and home equity line of credit mortgages are included in this category. First mortgage loans may include fixed rate loans that are generally sold to investors. The Bank is a direct seller to the Federal National Mortgage Association (“FNMA”), Federal Home Loan Mortgage Corporation (“FHLMC”) and to several large financial institutions. The Bank typically retains servicing rights for sold mortgages. The retention of such servicing rights also allows the Bank an opportunity to have regular contact with mortgage customers and can help to solidify community involvement. Other loans that are not sold include adjustable rate mortgages, lot loans, and construction loans that are held in the Bank’s portfolio. Residential mortgage purchase activity has reflected a moderate level of activity as the real estate market in our market area continues to stabilize. However, with continuing lower interest rates and increased stabilization in our market area, the Bank’s residential mortgage lending reflects a steady volume and mixture of both refinance and purchase financing opportunities. Home equity lending has continued to slow in the past year but is still a meaningful portion of the Bank’s business.

Consumer Loans. The Bank also provides many types of consumer loans including primarily motor vehicle, home improvement and signature loans. Consumer loans typically have shorter terms and lower balances with higher yields as compared to other loans but generally carry higher risks of default. Consumer loan collections are dependent on the borrower’s continuing financial stability and thus are more likely to be affected by adverse personal circumstances.

Competition

The Company's market area is highly competitive and the Bank's business activities require it to compete with many other financial institutions. A number of these financial institutions are affiliated with large bank holding companies headquartered outside of our principal market area as well as other institutions that are based in Aurora's surrounding communities and in Chicago, Illinois. All of these financial institutions operate banking offices in the greater Aurora area or actively compete for customers within the Company's market area. The Bank also faces competition from finance companies, insurance companies, credit unions, mortgage companies, securities brokerage firms, money market funds, loan production offices and other providers of financial services. Many of our nonbank competitors are not subject to the same extensive federal regulations that govern bank holding companies and banks, such as the Company, may have certain competitive advantages.

The Bank competes for loans principally through the quality of its client service and its responsiveness to client needs in addition to competing on interest rates and loan fees. Management believes that its long-standing presence in the community and personal one-on-one service philosophy enhances its ability to compete favorably in attracting and retaining individual and business customers. The Bank actively solicits deposit-related clients and competes for deposits by offering personal attention, competitive interest rates, and professional services made available through experienced bankers and multiple delivery channels that fit the needs of its market.

The Bank operated 24 branches in the seven counties of Kane, Kendall, LaSalle, Will, DeKalb, DuPage, and Cook County as of December 31, 2015. The financial services industry will continue to become more competitive as further technological advances enable more financial institutions to provide expanded financial services without having a physical presence in our market.

Employees

At December 31, 2015, 2014 and 2013, the Company employed 450, 485 and 492 full-time equivalent employees, respectively