OLD SECOND BANCORP INC
Form 10-Q
August 08, 2016
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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 June 30, 2016

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

(Exact name of Registrant as specified in its charter)

| | |
|---|---|
| Delaware | 36-3143493 |
| (State or other jurisdiction | (I.R.S. Employer Identification Number) |

of incorporation or organization)

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 August 5, 2016, the Registrant had outstanding 29,554,716 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) June 30, 2016 | December 31, 2015 |
|---|---|---|
| Assets | | |
| Cash and due from banks | $ 32,806 | $ 26,975 |
| Interest bearing deposits with financial institutions | 7,525 | 13,363 |
| Cash and cash equivalents | 40,331 | 40,338 |
| Securities available-for-sale, at fair value | 764,551 | 456,066 |
| Securities held-to-maturity, at amortized cost | - | 247,746 |
| Federal Home Loan Bank and Federal Reserve Bank stock | 7,918 | 8,518 |
| Loans held-for-sale | 5,589 | 2,849 |
| Loans | 1,161,151 | 1,133,715 |
| Less: allowance for loan losses | 15,822 | 16,223 |
| Net loans | 1,145,329 | 1,117,492 |
| Premises and equipment, net | 38,953 | 39,612 |
| Other real estate owned | 16,252 | 19,141 |
| Mortgage servicing rights, net | 4,698 | 5,847 |
| Bank-owned life insurance (BOLI) | 59,653 | 59,049 |
| Deferred tax assets, net | 57,738 | 64,552 |
| Other assets | 18,762 | 15,818 |
| Total assets | $ 2,159,774 | $ 2,077,028 |
| | | |
| Liabilities | | |
| Deposits: | | |
| Noninterest bearing demand | $ 477,883 | $ 442,639 |
| Interest bearing: | | |
| Savings, NOW, and money market | 902,576 | 908,598 |
| Time | 401,666 | 407,849 |
| Total deposits | 1,782,125 | 1,759,086 |
| Securities sold under repurchase agreements | 43,138 | 34,070 |
| Other short-term borrowings | 50,000 | 15,000 |
| Junior subordinated debentures | 57,567 | 57,543 |
| Subordinated debt | 45,000 | 45,000 |
| Notes payable and other borrowings | 500 | 500 |
| Other liabilities | 13,823 | 9,900 |
| Total liabilities | 1,992,153 | 1,921,099 |

| | | |
|---|---|---|
| Stockholders' Equity | | |
| Common stock | 34,533 | 34,427 |
| Additional paid-in capital | 116,311 | 115,918 |
| Retained earnings | 121,080 | 114,209 |
| Accumulated other comprehensive loss | (8,083) | (12,659) |
| Treasury stock | (96,220) | (95,966) |
| Total stockholders' equity | 167,621 | 155,929 |
| Total liabilities and stockholders' equity | $ 2,159,774 | $ 2,077,028 |

| | June 30, 2016 | | December 31, 2015 | |
|---|---|---|---|---|
| | Preferred Stock | Common Stock | Preferred Stock | Common Stock |
| Par value | $ 1 | $ 1 | $ 1 | $ 1 |
| Liquidation value | - | N/A | - | N/A |
| Shares authorized | 300,000 | 60,000,000 | 300,000 | 60,000,000 |
| Shares issued | - | 34,532,734 | - | 34,427,234 |
| Shares outstanding | - | 29,554,716 | - | 29,483,429 |
| Treasury shares | - | 4,978,018 | - | 4,943,805 |

See accompanying notes to consolidated financial statements.

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Old Second Bancorp, Inc. and Subsidiaries

Consolidated Statements of Income

(In thousands, except per share data)

| | (unaudited) Three Months Ended June 30, | | (unaudited) Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2016 | 2015 | 2016 | 2015 |
| Interest and dividend income | | | | |
| Loans, including fees | $ 13,039 | $ 13,467 | $ 26,097 | $ 26,685 |
| Loans held-for-sale | 39 | 72 | 67 | 115 |
| Securities: | | | | |
| Taxable | 4,382 | 3,372 | 8,593 | 6,747 |
| Tax exempt | 220 | 163 | 399 | 304 |
| Dividends from Federal Reserve Bank and Federal Home Loan Bank stock | 84 | 77 | 168 | 154 |
| Interest bearing deposits with financial institutions | 15 | 19 | 34 | 31 |
| Total interest and dividend income | 17,779 | 17,170 | 35,358 | 34,036 |
| Interest expense | | | | |
| Savings, NOW, and money market deposits | 193 | 183 | 384 | 362 |
| Time deposits | 869 | 771 | 1,691 | 1,578 |
| Other short-term borrowings | 26 | 7 | 46 | 16 |
| Junior subordinated debentures | 1,083 | 1,071 | 2,167 | 2,143 |
| Subordinated debt | 243 | 202 | 482 | 399 |
| Notes payable and other borrowings | 2 | - | 4 | 4 |
| Total interest expense | 2,416 | 2,234 | 4,774 | 4,502 |
| Net interest and dividend income | 15,363 | 14,936 | 30,584 | 29,534 |
| Loan loss reserve release | - | (2,300) | - | (2,300) |
| Net interest and dividend income after release for loan losses | 15,363 | 17,236 | 30,584 | 31,834 |
| Noninterest income | | | | |
| Trust income | 1,502 | 1,596 | 2,871 | 3,082 |
| Service charges on deposits | 1,646 | 1,779 | 3,205 | 3,320 |
| Secondary mortgage fees | 280 | 281 | 473 | 525 |
| Mortgage servicing (loss) / gain, net of changes in fair value | (311) | 500 | (931) | 292 |
| Net gain on sales of mortgage loans | 1,642 | 1,695 | 2,854 | 3,318 |
| Securities loss, net | - | (12) | (61) | (121) |
| Increase in cash surrender value of bank-owned life insurance | 319 | 299 | 604 | 779 |
| Debit card interchange income | 1,049 | 1,050 | 1,996 | 2,009 |
| Other income | 1,150 | 1,076 | 2,541 | 3,033 |
| Total noninterest income | 7,277 | 8,264 | 13,552 | 16,237 |
| Noninterest expense | | | | |
| Salaries and employee benefits | 8,814 | 9,149 | 17,840 | 18,404 |
| Occupancy expense, net | 1,009 | 1,094 | 2,238 | 2,365 |
| Furniture and equipment expense | 1,078 | 1,065 | 2,036 | 2,066 |

| | | | | |
|---|---|---|---|---|
| FDIC insurance | 362 | 377 | 565 | 650 |
| General bank insurance | 272 | 310 | 570 | 667 |
| Advertising expense | 435 | 353 | 782 | 558 |
| Debit card interchange expense | 620 | 400 | 823 | 752 |
| Legal fees | 191 | 420 | 352 | 643 |
| Other real estate expense, net | 879 | 2,388 | 1,617 | 3,740 |
| Other expense | 3,040 | 3,371 | 6,141 | 6,235 |
| Total noninterest expense | 16,700 | 18,927 | 32,964 | 36,080 |
| Income before income taxes | 5,940 | 6,573 | 11,172 | 11,991 |
| Provision for income taxes | 2,095 | 2,444 | 4,005 | 4,363 |
| Net income | $ 3,845 | $ 4,129 | $ 7,167 | $ 7,628 |
| Preferred stock dividends and accretion of discount | - | 710 | - | 1,534 |
| Net income available to common stockholders | $ 3,845 | $ 3,419 | $ 7,167 | $ 6,094 |
| | | | | |
| Basic earnings per share | $ 0.13 | $ 0.12 | $ 0.24 | $ 0.21 |
| Diluted earnings per share | 0.13 | 0.12 | 0.24 | 0.21 |

See accompanying notes to consolidated financial statements.

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Old Second Bancorp, Inc. and Subsidiaries

Consolidated Statements of Comprehensive Income

(In thousands)

| | (Unaudited) Three Months Ended June 30, | | (Unaudited) Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2016 | 2015 | 2016 | 2015 |
| Net Income | $ 3,845 | $ 4,129 | $ 7,167 | $ 7,628 |
| | | | | |
| Unrealized holding gains (losses) on available-for-sale securities arising during the period | 8,076 | (575) | 5,767 | 346 |
| Related tax (expense) benefit | (3,233) | 228 | (2,308) | (210) |
| Holding gains (losses) after tax on available-for-sale securities | 4,843 | (347) | 3,459 | 136 |
| | | | | |
| Less: Reclassification adjustment for the net losses realized during the period | | | | |
| Net realized losses | - | (12) | (61) | (121) |
| Income tax benefit on net realized losses | - | 3 | 25 | 48 |
| Net realized losses after tax | - | (9) | (36) | (73) |
| Other comprehensive income (loss) on available-for-sale securities | 4,843 | (338) | 3,495 | 209 |
| | | | | |
| Accretion and reversal of net unrealized holding gains on held-to-maturity securities | 5,715 | 254 | 5,939 | 497 |
| Related tax expense | (2,354) | (104) | (2,446) | (204) |
| Other comprehensive income on held-to-maturity securities | 3,361 | 150 | 3,493 | 293 |
| | | | | |
| Changes in fair value of derivatives used for cashflow hedges | (1,597) | - | (4,024) | - |
| Related tax benefit | 640 | - | 1,612 | - |
| Other comprehensive loss on cashflow hedges | (957) | - | (2,412) | - |
| | | | | |
| Total other comprehensive income (loss) | 7,247 | (188) | 4,576 | 502 |
| Total comprehensive income | $ 11,092 | $ 3,941 | $ 11,743 | $ 8,130 |

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) Six Months Ended June 30, 2016 | 2015 |
|---|---|---|
| Cash flows from operating activities | | |
| Net income | $ 7,167 | $ 7,628 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization of leasehold improvement | 1,097 | 1,216 |
| Change in fair value of mortgage servicing rights | 1,774 | 513 |
| Loan loss reserve release | - | (2,300) |
| Provision for deferred tax expense | 3,717 | 4,206 |
| Originations of loans held-for-sale | (83,698) | (114,718) |
| Proceeds from sales of loans held-for-sale | 83,324 | 115,940 |
| Net gain on sales of mortgage loans | (2,854) | (3,318) |
| Change in current income taxes receivable | 259 | 27 |
| Increase in cash surrender value of bank-owned life insurance | (604) | (392) |
| Change in accrued interest receivable and other assets | (3,152) | (2,167) |
| Change in accrued interest payable and other liabilities | (185) | (2,475) |
| Net premium (accretion)/amortization/discount on securities | (385) | 154 |
| Securities losses, net | 61 | 121 |
| Amortization of junior subordinated debentures issuance costs | 24 | 24 |
| Stock based compensation | 325 | 344 |
| Net gain on sale of other real estate owned | (67) | (337) |
| Provision for other real estate owned losses | 940 | 2,697 |
| Net cash provided by operating activities | 7,743 | 7,163 |
| Cash flows from investing activities | | |
| Proceeds from maturities and calls including pay down of securities available-for-sale | 25,687 | 28,292 |
| Proceeds from sales of securities available-for-sale | 44,993 | 56,121 |
| Purchases of securities available-for-sale | (122,700) | (98,806) |
| Proceeds from maturities and calls including pay down of securities held-to-maturity | 3,372 | 6,983 |
| Proceeds from sales of Federal Home Loan Bank stock | 600 | 787 |
| Net change in loans | (28,805) | (7,582) |
| Improvements in other real estate owned | (12) | - |
| Proceeds from sales of other real estate owned | 2,996 | 4,673 |
| Net purchases of premises and equipment | (438) | (577) |
| Net cash used in investing activities | (74,307) | (10,109) |
| Cash flows from financing activities | | |
| Net change in deposits | 23,039 | 28,497 |
| Net change in securities sold under repurchase agreements | 9,068 | 11,379 |
| Net change in other short-term borrowings | 35,000 | (25,000) |

| | | |
|---|---|---|
| Redemption of preferred stock | - | (15,778) |
| Dividends paid preferred stock | - | (1,716) |
| Dividends paid common stock | (296) | - |
| Purchase of treasury stock | (254) | (117) |
| Net cash provided by (used in) financing activities | 66,557 | (2,735) |
| Net change in cash and cash equivalents | (7) | (5,681) |
| Cash and cash equivalents at beginning of period | 40,338 | 44,197 |
| Cash and cash equivalents at end of period | $ 40,331 | $ 38,516 |

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Old Second Bancorp, Inc. and Subsidiaries

Consolidated Statements of Cash Flows - Continued

(In thousands)

| | (Unaudited) Six Months Ended June 30, | |
|---|---|---|
| Supplemental cash flow information | 2016 | 2015 |
| Income taxes paid, net | $ 100 | $ 130 |
| Interest paid for deposits | 2,053 | 1,993 |
| Interest paid for borrowings | 2,665 | 2,564 |
| Non-cash transfer of loans to other real estate owned | 968 | 7,015 |
| Non-cash transfer of securities held-to-maturity to securities available-for-sale | 244,823 | - |
| Change in dividends accrued and declared but not paid | - | (182) |

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 Loss | Treasury Stock | Total Stockholders' Equity |
|---|---|---|---|---|---|---|---|
| Balance, December 31, 2014 | $ 34,365 | $ 47,331 | $ 115,332 | $ 100,697 | $ (7,713) | $ (95,849) | $ 194,163 |
| Net income | | | | 7,628 | | | 7,628 |
| Other comprehensive gain, net of tax | | | | | 502 | | 502 |
| Change in restricted stock | 58 | | (58) | | | | - |
| Tax effect from vesting of restricted stock | | | 33 | | | | 33 |
| Stock based compensation | | | 344 | | | | 344 |
| Purchase of treasury stock | | | | | | (117) | (117) |
| Redemption of preferred stock | | (15,778) | | | | | (15,778) |
| Preferred stock accretion and declared dividends | | | | (1,534) | | | (1,534) |
| Balance, June 30, 2015 | $ 34,423 | $ 31,553 | $ 115,651 | $ 106,791 | $ (7,211) | $ (95,966) | $ 185,241 |
| | | | | | | | |
| Balance, December 31, 2015 | $ 34,427 | $ - | $ 115,918 | $ 114,209 | $ (12,659) | $ (95,966) | $ 155,929 |
| Net income | | | | 7,167 | | | 7,167 |
| Other comprehensive gain, net of tax | | | | | 4,576 | | 4,576 |
| Dividends declared and paid, $0.01 per share | | | | (296) | | | (296) |
| Change in restricted stock | 106 | | (106) | | | | - |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| Tax effect from vesting of restricted stock | | | 174 | | | | 174 |
| Stock based compensation | | | 325 | | | | 325 |
| Purchase of treasury stock | | | | | | (254) | (254) |
| Balance, June 30, 2016 | $ 34,533 | $ - | $ 116,311 | $ 121,080 | $ (8,083) | $ (96,220) | $ 167,621 |

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 that are necessary, in the opinion of management, for a fair statement of results for the interim period presented. Results for the period ended June 30, 2016, are not necessarily indicative of the results that may be expected for the year ending December 31, 2016. 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, 2015. 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, 2015. 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 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. In August 2015, the FASB issued ASU 2015-14 “Revenue from Contracts with Customers (Topic 606) Deferral of the Effective Date.” This accounting standards update defers the effective date of ASU 2014-09 for an additional year. ASU 2015-14 will be effective for annual reporting periods beginning after December 15, 2017. 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. In March 2016, the FASB issued ASU 2016-08 “Revenue from Contracts with Customers (TOPIC 606): Principal versus Agent Considerations (Reporting Revenue Gross versus Net).” and in April 2016, the FASB issued ASU 2016-10 “Revenue from Contracts with Customers (TOPIC 606): Identifying Performance Obligations and Licensing.” ASU 2016-08 requires the entity to determine if it is acting as a principal with control over the goods or services it is contractually obligated to provide, or an agent with no control over specified goods or services provided by another party to a customer. ASU 2016-10 was issued to further clarify ASU 2014-09 implementation regarding identifying performance obligation materiality, identification of key contract components, and scope. The Company is assessing the impact of ASU 2014-09 and other related ASUs as noted above on its accounting and disclosures.

In April 2015, the FASB issued ASU No. 2015-03 “Simplifying the Presentation of Debt Issuance Costs.” ASU 2015-03 amended prior guidance to simplify the presentation of debt issuance costs. The amendments in this ASU require that debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of that debt liability, consistent with debt discounts. ASU 2015-03 is effective for financial statements issued for fiscal years beginning after December 15, 2015, and interim periods within those fiscal years. The adoption of this standard did not have a material effect to the Company’s operating results or financial condition. This standard was adopted by the Company effective January 2016.

In March 2016, the FASB issued ASU No. 2016-09 “Improvements to Employee Share-Based Payment Accounting:” FASB issued this AS U as part of the Simplification Initiative. This ASU involves several aspects of the accounting for share-based payment transactions, including the income tax consequences, classification of awards as either equity or liability, and classification on the statement of cash flows. ASU 2016-09 is effective for financial statements issued for fiscal years beginning after December 15, 2016. The Company is assessing the impact of ASU 2016-09 on its accounting and disclosures.

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In June 2016, the FASB issued ASU No. 2016-13 “Measurement of Credit Losses on Financial Instruments:” ASU 2016-13 was issued to provide financial statement users with more useful information about the expected credit losses on financial instruments and other commitments to extend credit held by a reporting entity at each reporting date to enhance the decision making process. ASU 2016-13 is effective for financial statements issued for fiscal years beginning after December 15, 2019. The Company is assessing the impact of ASU 2016-13 on its accounting and disclosures.

Subsequent Events

On July 19, 2016, the Company’s Board of Directors declared a cash dividend of 1 cent per share payable on August 9, 2016, to stockholders of record as of July 29, 2016.

On August 1, 2016, the Company announced the Bank has agreed to acquire the Chicago branch of Talmer Bank and Trust, the banking subsidiary of Talmer Bancorp, Inc. (“Talmer”), including approximately $82 million of deposits and $237 million of loans. The acquisition is expected to close in the fourth quarter of 2016, subject to regulatory approval, the completion of Talmer’s pending merger with Chemical Financial Corporation and other customary closing conditions.

Note 2 – Securities

Investment Portfolio Management

Our investment portfolio serves the liquidity needs and income objectives of the Company. While the portfolio serves as an important component of the overall liquidity management at the Bank, portions of the portfolio 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.

In the second quarter of 2016, the securities held-to-maturity portfolio was reclassified to available-for-sale to allow for portfolio restructuring and to fund loan growth. This transfer of $244.8 million was approved by the Board of Directors, and will preclude any holdings of securities held-to-maturity for a two year period.

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 $3.2 million at June 30, 2016, and $3.7 million at December 31, 2015. Reserve Bank stock was recorded at $4.8 million at June 30, 2016, and December 31, 2015. 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 June 30, 2016, and December 31, 2015, and the corresponding amounts of gross unrealized gains and losses (in thousands):

| June 30, 2016 | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|---|---|---|---|
| Securities available-for-sale | | | | |
| U.S. government agencies | $ 1,668 | $ - | $ (146) | $ 1,522 |
| U.S. government agencies mortgage-backed | 42,780 | 868 | (2) | 43,646 |
| States and political subdivisions | 41,830 | 791 | - | 42,621 |
| Corporate bonds | 30,505 | 227 | (524) | 30,208 |
| Collateralized mortgage obligations | 284,538 | 5,414 | (727) | 289,225 |
| Asset-backed securities | 262,625 | 568 | (12,234) | 250,959 |
| Collateralized loan obligations | 109,430 | 76 | (3,136) | 106,370 |
| Total securities available-for-sale | $ 773,376 | $ 7,944 | $ (16,769) | $ 764,551 |

| December 31, 2015 | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|---|---|---|---|
| Securities available-for-sale | | | | |
| U.S. Treasury | $ 1,509 | $ - | $ - | $ 1,509 |
| U.S. government agencies | 1,683 | - | (127) | 1,556 |
| U.S. government agencies mortgage-backed | 2,040 | | (44) | 1,996 |
| States and political subdivisions | 30,341 | 285 | (100) | 30,526 |
| Corporate bonds | 30,157 | - | (757) | 29,400 |
| Collateralized mortgage obligations | 68,743 | 24 | (1,847) | 66,920 |
| Asset-backed securities | 241,872 | 74 | (10,038) | 231,908 |
| Collateralized loan obligations | 94,374 | - | (2,123) | 92,251 |
| Total securities available-for-sale | $ 470,719 | $ 383 | $ (15,036) | $ 456,066 |
| Securities held-to-maturity | | | | |
| U.S. government agency mortgage-backed | $ 36,505 | $ 1,592 | $ - | $ 38,097 |
| Collateralized mortgage obligations | 211,241 | 3,302 | (965) | 213,578 |
| Total securities held-to-maturity | $ 247,746 | $ 4,894 | $ (965) | $ 251,675 |

The fair value, amortized cost and weighted average yield of debt securities at June 30, 2016, by contractual maturity, were as follows in the table below. Securities not due at a single maturity date are shown separately.

| Securities available-for-sale | Amortized Cost | Weighted Average Yield | | Fair Value |
|---|---|---|---|---|
| Due in one year or less | $ 20,633 | 1.84 | % | $ 20,674 |
| Due after one year through five years | 6,621 | 2.53 | % | 6,718 |
| Due after five years through ten years | 36,167 | 2.35 | % | 36,216 |
| Due after ten years | 10,582 | 1.76 | % | 10,743 |
| | 74,003 | 2.14 | % | 74,351 |
| Mortgage-backed and collateralized mortgage obligations | 327,318 | 2.52 | % | 332,871 |
| Asset-backed securities | 262,625 | 1.63 | % | 250,959 |
| Collateralized loan obligations | 109,430 | 3.51 | % | 106,370 |
| Total securities available-for-sale | $ 773,376 | 2.32 | % | $ 764,551 |

At June 30, 2016, the Company's investments include $228.0 million of asset-backed securities that are backed by student loans originated under the Federal Family Education Loan program ("FFEL"). Under the FFEL, private lenders made federally guaranteed student loans to parents and students. While the program was modified several times before elimination in 2010, not less than 97% of the outstanding principal amount of the loans made under FFEL are guaranteed by the U.S. Department of Education. In addition to the U.S. Department of Education guarantee, total added credit enhancement in the form of overcollateralization and/or subordination amounted to $15.7 million, or 6.36%, of outstanding principal. A number of major student loan originators packaged loans and sold them as asset-backed securities.

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Securities with unrealized losses at June 30, 2016, and December 31, 2015, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, were as follows (in thousands except for number of securities):

| ne 30, 2016 | Less than 12 months in an unrealized loss position | | | Greater than 12 months in an unrealized loss position | | | Total | | |
|---|---|---|---|---|---|---|---|---|---|
| ecurities vailable-for-sale | Number of Securities | Unrealized Losses | Fair Value | Number of Securities | Unrealized Losses | Fair Value | Number of Securities | Unrealized Losses | Fair Value |
| .S. government gencies | - | $ - | $ - | 1 | $ 146 | $ 1,522 | 1 | $ 146 | $ 1,522 |
| .S. government gencies ortgage-backed | 1 | 2 | 928 | - | - | - | 1 | 2 | 928 |
| ates and litical bdivisions | - | - | - | - | - | - | - | - | - |
| orporate bonds | 2 | 29 | 5,446 | 5 | 495 | 14,535 | 7 | 524 | 19,981 |
| ollateralized ortgage oligations | 9 | 218 | 15,684 | 11 | 509 | 44,476 | 20 | 727 | 60,160 |
| sset-backed curities | 12 | 1,933 | 64,983 | 10 | 10,301 | 127,609 | 22 | 12,234 | 192,59 |
| ollateralized an obligations | 2 | 366 | 11,603 | 11 | 2,770 | 74,698 | 13 | 3,136 | 86,301 |
| otal securities vailable-for-sale | 26 | $ 2,548 | $ 98,644 | 38 | $ 14,221 | $ 262,840 | 64 | $ 16,769 | $ 361,48 |

| ember 31, 2015 | Less than 12 months in an unrealized loss position | | | Greater than 12 months in an unrealized loss position | | | Total | | |
|---|---|---|---|---|---|---|---|---|---|
| urities ilable-for-sale | Number of Securities | Unrealized Losses | Fair Value | Number of Securities | Unrealized Losses | Fair Value | Number of Securities | Unrealized Losses | Fair Valu |
| . government ncies | - | $ - | $ - | 1 | $ 127 | $ 1,556 | 1 | $ 127 | $ 1,55 |
| . government ncies rtgage-backed | 1 | 44 | 1,996 | - | - | - | 1 | 44 | 1,99 |
| es and political divisions | 2 | 19 | 1,541 | 1 | 81 | 1,713 | 3 | 100 | 3,25 |
| porate bonds | 5 | 292 | 14,866 | 3 | 465 | 14,534 | 8 | 757 | 29,4 |
| | 4 | 334 | 16,218 | 7 | 1,513 | 43,618 | 11 | 1,847 | 59,8 |

| | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| lateralized rtgage gations et-backed urities | 9 | 2,080 | 78,301 | 8 | 7,958 | 121,217 | 17 | 10,038 | 199, |
| lateralized loan gations | 5 | 446 | 29,480 | 9 | 1,677 | 62,771 | 14 | 2,123 | 92,2 |
| al securities ilable-for-sale urities | 26 | $ 3,215 | $ 142,402 | 29 | $ 11,821 | $ 245,409 | 55 | $ 15,036 | $ 387, |
| l-to-maturity | | | | | | | | | |
| lateralized rtgage gations | 8 | $ 505 | $ 40,307 | 2 | $ 460 | $ 33,842 | 10 | $ 965 | $ 74,1 |
| al securities l-to-maturity | 8 | $ 505 | $ 40,307 | 2 | $ 460 | $ 33,842 | 10 | $ 965 | $ 74,1 |

Recognition of other-than-temporary impairment was not necessary in the three and six months ending June 30, 2016, or the year ended December 31, 2015. The changes in fair value related primarily to interest rate fluctuations. Our review of other-than-temporary impairment determined that there was no credit quality deterioration.

Note 3 – Loans

Major classifications of loans were as follows:

| | June 30, 2016 | December 31, 2015 |
|---|---|---|
| Commercial | $ 156,562 | $ 130,362 |
| Real estate - commercial | 600,942 | 605,721 |
| Real estate - construction | 22,204 | 19,806 |
| Real estate - residential | 352,595 | 351,007 |
| Consumer | 2,966 | 4,216 |
| Overdraft | 504 | 483 |
| Lease financing receivables | 13,160 | 10,953 |
| Other | 11,127 | 10,130 |
| | 1,160,060 | 1,132,678 |
| Net deferred loan costs | 1,091 | 1,037 |
| Total loans | $ 1,161,151 | $ 1,133,715 |

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. With selected exceptions, the Bank 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 84.0% and 86.1% of the portfolio at June 30, 2016, and December 31, 2015, respectively.

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

| June 30, 2016 | 30-59 Days Past Due | 60-89 Days Past Due | 90 Days or Greater Past Due | Total Past Due | Current | Nonaccrual | Total Loans | Recorded Investment 90 days or Greater Past Due and Accruing |
|---|---|---|---|---|---|---|---|---|
| Commercial1 | $ 337 | $ - | $ - | $ 337 | $ 168,857 | $ 528 | $ 169,722 | $ - |
| Real estate - commercial | | | | | | | | |
| Owner occupied general purpose | - | - | - | - | 123,080 | 1,643 | 124,723 | - |
| Owner occupied special purpose | - | - | - | - | 164,610 | 537 | 165,147 | - |
| Non-owner occupied general purpose | - | 429 | - | 429 | 157,025 | 2,644 | 160,098 | - |
| Non-owner occupied special purpose | - | - | - | - | 104,296 | 1,649 | 105,945 | - |
| Retail properties | - | - | - | - | 29,306 | 2,034 | 31,340 | - |
| Farm | 112 | - | - | 112 | 13,577 | - | 13,689 | - |
| Real estate - construction | | | | | | | | |
| Homebuilder | 22 | - | - | 22 | 779 | - | 801 | - |
| Land | - | - | - | - | 1,154 | - | 1,154 | - |
| Commercial speculative | - | - | - | - | 5,023 | 78 | 5,101 | - |
| All other | - | - | - | - | 15,148 | - | 15,148 | - |
| Real estate - residential | | | | | | | | |
| Investor | - | 216 | - | 216 | 128,530 | 931 | 129,677 | - |
| Owner occupied | - | 26 | - | 26 | 116,186 | 5,757 | 121,969 | - |
| Revolving and junior liens | 210 | 16 | - | 226 | 98,264 | 2,459 | 100,949 | - |
| Consumer | - | - | - | - | 2,966 | - | 2,966 | - |
| Other2 | - | - | - | - | 12,722 | - | 12,722 | - |
| Total | $ 681 | $ 687 | $ - | $ 1,368 | $ 1,141,523 | $ 18,260 | $ 1,161,151 | $ - |

| December 31, 2015 | 30-59 Days Past Due | 60-89 Days Past Due | 90 Days or Greater Past Due | Total Past Due | Current | Nonaccrual | Total Loans | Recorded Investment 90 days or Greater Past Due and Accruing |
|---|---|---|---|---|---|---|---|---|
| Commercial1 | $ 394 | $ - | $ - | $ 394 | $ 140,848 | $ 73 | $ 141,315 | $ - |
| Real estate - commercial | | | | | | | | |
| Owner occupied general purpose | 652 | 119 | - | 771 | 123,479 | 1,254 | 125,504 | - |
| Owner occupied special purpose | 358 | - | - | 358 | 170,827 | 763 | 171,948 | - |
| Non-owner occupied general purpose | - | - | - | - | 166,668 | 975 | 167,643 | - |
| Non-owner occupied special purpose | - | - | - | - | 92,387 | - | 92,387 | - |
| Retail properties | - | - | - | - | 34,352 | - | 34,352 | - |
| Farm | - | - | - | - | 12,615 | 1,272 | 13,887 | - |
| Real estate - construction | | | | | | | | |
| Homebuilder | - | - | - | - | 2,604 | - | 2,604 | - |
| Land | - | - | - | - | 1,137 | - | 1,137 | - |
| Commercial speculative | - | - | - | - | 2,117 | 83 | 2,200 | - |
| All other | 6 | 77 | 65 | 148 | 13,717 | - | 13,865 | 65 |
| Real estate - residential | | | | | | | | |
| Investor | 101 | - | - | 101 | 125,611 | 972 | 126,684 | - |
| Owner occupied | 1,083 | 446 | - | 1,529 | 110,885 | 6,378 | 118,792 | - |
| Revolving and junior liens | 344 | 68 | - | 412 | 102,500 | 2,619 | 105,531 | - |
| Consumer | 4 | - | - | 4 | 4,212 | - | 4,216 | - |
| Other2 | - | - | - | - | 11,650 | - | 11,650 | - |
| Total | $ 2,942 | $ 710 | $ 65 | $ 3,717 | $ 1,115,609 | $ 14,389 | $ 1,133,715 | $ 65 |

1 The “Commercial” class includes lease financing receivables.

2 The “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:

| June 30, 2016 | Pass | Special Mention | Substandard 1 | Doubtful | Total |
|---|---|---|---|---|---|
| Commercial | $ 165,331 | $ 1,932 | $ 2,459 | $ - | $ 169,722 |
| Real estate - commercial | | | | | |
| Owner occupied general purpose | 122,135 | 56 | 2,532 | - | 124,723 |
| Owner occupied special purpose | 162,257 | 2,353 | 537 | - | 165,147 |
| Non-owner occupied general purpose | 156,773 | 252 | 3,073 | - | 160,098 |
| Non-owner occupied special purpose | 100,456 | - | 5,489 | - | 105,945 |
| Retail Properties | 27,846 | 1,460 | 2,034 | - | 31,340 |
| Farm | 12,278 | 1,355 | 56 | - | 13,689 |
| Real estate - construction | | | | | |
| Homebuilder | 801 | - | - | - | 801 |
| Land | 1,154 | - | - | - | 1,154 |
| Commercial speculative | 5,023 | - | 78 | - | 5,101 |
| All other | 14,969 | - | 179 | - | 15,148 |
| Real estate - residential | | | | | |
| Investor | 128,367 | - | 1,310 | - | 129,677 |
| Owner occupied | 115,429 | - | 6,540 | - | 121,969 |
| Revolving and junior liens | 97,579 | - | 3,370 | - | 100,949 |
| Consumer | 2,965 | - | 1 | - | 2,966 |
| Other | 12,692 | 30 | - | - | 12,722 |
| Total | $ 1,126,055 | $ 7,438 | $ 27,658 | $ - | $ 1,161,151 |

| December 31, 2015 | Pass | Special Mention | Substandard 1 | Doubtful | Total |
|---|---|---|---|---|---|
| Commercial | $ 136,078 | $ 3,208 | $ 2,029 | $ - | $ 141,315 |
| Real estate - commercial | | | | | |
| Owner occupied general purpose | 123,827 | - | 1,677 | - | 125,504 |
| Owner occupied special purpose | 171,185 | - | 763 | - | 171,948 |
| Non-owner occupied general purpose | 163,956 | 1,908 | 1,779 | - | 167,643 |
| Non-owner occupied special purpose | 88,468 | - | 3,919 | - | 92,387 |
| Retail Properties | 30,432 | 1,490 | 2,430 | - | 34,352 |
| Farm | 12,615 | - | 1,272 | - | 13,887 |
| Real estate - construction | | | | | |
| Homebuilder | 2,604 | - | - | - | 2,604 |
| Land | 1,137 | - | - | - | 1,137 |
| Commercial speculative | 2,117 | - | 83 | - | 2,200 |
| All other | 13,865 | - | - | - | 13,865 |
| Real estate - residential | | | | | |
| Investor | 125,548 | - | 1,136 | - | 126,684 |
| Owner occupied | 111,713 | - | 7,079 | - | 118,792 |
| Revolving and junior liens | 102,476 | - | 3,055 | - | 105,531 |
| Consumer | 4,215 | - | 1 | - | 4,216 |
| Other | 11,650 | - | - | - | 11,650 |
| Total | $ 1,101,886 | $ 6,606 | $ 25,223 | $ - | $ 1,133,715 |

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

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The Company had $2.5 million and $3.9 million residential assets in the process of foreclosure as of June 30, 2016, and December 31, 2015, respectively.

Impaired loans by class of loans for the June 2016 periods listed were as follows:

| | As of June 30, 2016 | | | Six Months Ended June 30, 2016 | |
|---|---|---|---|---|---|
| | Recorded Investment | Unpaid Principal Balance | Related Allowance | Average Recorded Investment | Interest Income Recognized |
| With no related allowance recorded | | | | | |
| Commercial | $ 528 | $ 608 | $ - | $ 299 | $ - |
| Commercial real estate | | | | | |
| Owner occupied general purpose | 2,674 | 3,056 | - | 2,494 | 44 |
| Owner occupied special purpose | 537 | 659 | - | 650 | - |
| Non-owner occupied general purpose | 2,098 | 2,455 | - | 1,573 | 1 |
| Non-owner occupied special purpose | - | - | - | - | - |
| Retail properties | 2,034 | 2,386 | - | 1,017 | - |
| Farm | - | - | - | 636 | - |
| Construction | | | | | |
| Homebuilder | - | - | - | - | - |
| Land | - | - | - | - | - |
| Commercial speculative | 78 | 84 | - | 80 | - |
| All other | - | - | - | - | - |
| Residential | | | | | |
| Investor | 1,851 | 2,170 | - | 1,879 | 23 |
| Owner occupied | 9,709 | 11,287 | - | 10,124 | 79 |
| Revolving and junior liens | 2,615 | 3,915 | - | 2,673 | 6 |
| Consumer | - | - | - | - | - |
| Total impaired loans with no recorded allowance | 22,124 | 26,620 | - | 21,425 | 153 |
| With an allowance recorded | | | | | |
| Commercial | - | 5 | - | 1 | - |
| Commercial real estate | | | | | |
| Owner occupied general purpose | - | - | - | - | - |
| Owner occupied special purpose | - | - | - | - | - |
| Non-owner occupied general purpose | 612 | 612 | 116 | 306 | - |
| Non-owner occupied special purpose | 1,649 | 1,649 | 636 | 825 | - |
| Retail properties | - | - | - | - | - |
| Farm | - | - | - | - | - |
| Construction | | | | | |
| Homebuilder | - | - | - | - | - |
| Land | - | - | - | - | - |
| Commercial speculative | - | - | - | - | - |

| | | | | | |
|---|---|---|---|---|---|
| All other | - | - | - | - | - |
| Residential | | | | | |
| Investor | - | - | - | - | - |
| Owner occupied | 333 | 333 | 6 | 222 | - |
| Revolving and junior liens | - | - | - | 23 | - |
| Consumer | - | - | - | - | - |
| Total impaired loans with a recorded allowance | 2,594 | 2,599 | 758 | 1,377 | - |
| Total impaired loans | $ 24,718 | $ 29,219 | $ 758 | $ 22,802 | $ 153 |

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Impaired loans by class of loans for the December and June 2015 periods listed were as follows:

| | As of December 31, 2015 | | | Six Months Ended June 30, 2015 | |
|---|---|---|---|---|---|
| | Recorded Investment | Unpaid Principal Balance | Related Allowance | Average Recorded Investment | Interest Income Recognized |
| With no related allowance recorded | | | | | |
| Commercial | $ 70 | $ 149 | $ - | $ 1,050 | $ - |
| Commercial real estate | | | | | |
| Owner occupied general purpose | 2,314 | 3,004 | - | 5,102 | 39 |
| Owner occupied special purpose | 763 | 871 | - | 1,470 | 12 |
| Non-owner occupied general purpose | 1,047 | 1,065 | - | 2,780 | - |
| Non-owner occupied special purpose | - | - | - | 711 | - |
| Retail properties | - | - | - | - | - |
| Farm | 1,272 | 1,338 | - | 636 | - |
| Construction | | | | | |
| Homebuilder | - | - | - | 896 | - |
| Land | - | - | - | - | - |
| Commercial speculative | 83 | 86 | - | 1,736 | - |
| All other | - | - | - | 260 | - |
| Residential | | | | | |
| Investor | 1,906 | 2,259 | - | 2,057 | 19 |
| Owner occupied | 10,539 | 11,999 | - | 11,427 | 90 |
| Revolving and junior liens | 2,731 | 3,947 | - | 2,337 | 2 |
| Consumer | - | - | - | - | - |
| Total impaired loans with no recorded allowance | 20,725 | 24,718 | - | 30,462 | 162 |
| With an allowance recorded | | | | | |
| Commercial | 3 | 8 | 3 | - | - |
| Commercial real estate | | | | | |
| Owner occupied general purpose | - | - | - | - | - |
| Owner occupied special purpose | - | - | - | - | - |
| Non-owner occupied general purpose | - | - | - | 38 | - |
| Non-owner occupied special purpose | - | - | - | 89 | 9 |
| Retail properties | - | - | - | - | - |
| Farm | - | - | - | - | - |
| Construction | | | | | |
| Homebuilder | - | - | - | - | - |
| Land | - | - | - | - | - |
| Commercial speculative | - | - | - | - | - |
| All other | - | - | - | 260 | - |
| Residential | | | | | |
| Investor | - | - | - | 68 | - |
| Owner occupied | 112 | 112 | 31 | 18 | - |
| Revolving and junior liens | 46 | 46 | - | 416 | 2 |

| | | | | | |
|---|---|---|---|---|---|
| Consumer | - | - | - | - | - |
| Total impaired loans with a recorded allowance | 161 | 166 | 34 | 889 | 11 |
| Total impaired loans | $ 20,886 | $ 24,884 | $ 34 | $ 31,351 | $ 173 |

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

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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.

TDRs that were modified during the period are as follows:

| | TDR Modifications Three Months Ended June 30, 2016 | | | TDR Modifications Six Months Ended June 30, 2016 | | |
|---|---|---|---|---|---|---|
| | # 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 | $ 312 | $ 220 |
| Real estate - residential | | | | | | |
| Owner occupied | | | | | | |
| HAMP2 | - | - | - | 1 | 239 | 237 |
| Revolving and junior liens | | | | | | |
| HAMP2 | 1 | 39 | 39 | 4 | 469 | 438 |
| Total | 1 | $ 39 | $ 39 | 7 | $ 1,020 | $ 895 |

| | TDR Modifications Three Months Ended June 30, 2015 | | | TDR Modifications Six Months Ended June 30, 2015 | | |
|---|---|---|---|---|---|---|
| | # 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 | | | | | | |
| Bifurcate3 | - | $ - | $ - | 1 | $ 300 | $ 177 |
| Real estate - residential | | | | | | |
| Owner occupied | | | | | | |
| Other1 | 1 | 46 | 45 | 3 | 404 | 414 |

| | | | | | | |
|---|---|---|---|---|---|---|
| Revolving and junior liens | | | | | | |
| HAMP2 | 4 | 233 | 233 | 4 | 233 | 233 |
| Total | 5 | $ 279 | $ 278 | 8 | $ 937 | $ 824 |

1 Other: Change of terms from bankruptcy court

2 HAMP: Home Affordable Modification Program

3 Bifurcate: Refers to an “A/B” restructure separated into two notes, charging off the entire B portion of the note.

TDRs are classified as being in default on a case-by-case basis when they fail to be in compliance with the modified terms.  There was no TDR default activity for the three and six months ended June 30, 2016, and June 30, 2015, that was restructured within the 12 month period prior to default.

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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 three and six months ending June 30, 2016, were as follows:

| Allowance for loan losses: | Commercial | Real Estate Commercial | Real Estate Construction | Real Estate Residential | Consumer | Other | Total |
|---|---|---|---|---|---|---|---|
| Three months ended June 30, 2016 | | | | | | | |
| Beginning balance | $ 2,357 | $ 8,793 | $ 250 | $ 1,664 | $ 1,081 | $ 2,101 | $ 16,246 |
| Charge-offs | 8 | 690 | - | 171 | 67 | - | 936 |
| Recoveries | 8 | 145 | 6 | 290 | 63 | - | 512 |
| Provision (Release) | (662) | 706 | 124 | 1,150 | (215) | (1,103) | - |
| Ending balance | $ 1,695 | $ 8,954 | $ 380 | $ 2,933 | $ 862 | $ 998 | $ 15,822 |
| Six months ended June 30, 2016 | | | | | | | |
| Beginning balance | $ 2,096 | $ 9,013 | $ 265 | $ 1,694 | $ 1,190 | $ 1,965 | $ 16,223 |
| Charge-offs | 32 | 692 | - | 437 | 150 | - | 1,311 |
| Recoveries | 12 | 228 | 11 | 519 | 140 | - | 910 |
| Provision (Release) | (381) | 405 | 104 | 1,157 | (318) | (967) | - |
| Ending balance | $ 1,695 | $ 8,954 | $ 380 | $ 2,933 | $ 862 | $ 998 | $ 15,822 |
| Ending balance: Individually evaluated for impairment | $ - | $ 752 | $ - | $ 6 | $ - | $ - | $ 758 |
| Ending balance: Collectively evaluated for impairment | $ 1,695 | $ 8,202 | $ 380 | $ 2,927 | $ 862 | $ 998 | $ 15,064 |
| Loans: | | | | | | | |
| Ending balance | $ 169,722 | $ 600,942 | $ 22,204 | $ 352,595 | $ 2,966 | $ 12,722 | $ 1,161,151 |
| Ending balance: Individually evaluated for impairment | $ 528 | $ 9,604 | $ 78 | $ 14,508 | $ - | $ - | $ 24,718 |
| Ending balance: Collectively evaluated for impairment | $ 169,194 | $ 591,338 | $ 22,126 | $ 338,087 | $ 2,966 | $ 12,722 | $ 1,136,433 |

Changes in the allowance for loan losses by segment of loans based on method of impairment for June 30, 2015, were as follows:

| Allowance for loan losses: | Commercial | Real Estate Commercial | Real Estate Construction | Real Estate Residential | Consumer | Other | Total |
|---|---|---|---|---|---|---|---|
| Three months ended June 30, 2015 | | | | | | | |
| Beginning balance | $ 1,512 | $ 14,033 | $ 1,272 | $ 1,917 | $ 1,417 | $ 1,030 | $ 21,181 |
| Charge-offs | 858 | 1,031 | 1 | 159 | 93 | - | 2,142 |
| Recoveries | 83 | 965 | 61 | 403 | 70 | - | 1,582 |
| Provision (Release) | 895 | (3,766) | (670) | (301) | (145) | 1,687 | (2,300) |
| Ending balance | $ 1,632 | $ 10,201 | $ 662 | $ 1,860 | $ 1,249 | $ 2,717 | $ 18,321 |
| Six months ended June 30, 2015 | | | | | | | |
| Beginning balance | $ 1,644 | $ 12,577 | $ 1,475 | $ 1,981 | $ 1,454 | $ 2,506 | $ 21,637 |
| Charge-offs | 890 | 1,526 | 2 | 777 | 211 | - | 3,406 |
| Recoveries | 224 | 1,295 | 66 | 627 | 178 | - | 2,390 |
| Provision (Release) | 654 | (2,145) | (877) | 29 | (172) | 211 | (2,300) |
| Ending balance | $ 1,632 | $ 10,201 | $ 662 | $ 1,860 | $ 1,249 | $ 2,717 | $ 18,321 |
| Ending balance: Individually evaluated for impairment | $ - | $ - | $ 27 | $ 111 | $ - | $ - | $ 138 |
| Ending balance: Collectively evaluated for impairment | $ 1,632 | $ 10,201 | $ 635 | $ 1,749 | $ 1,249 | $ 2,717 | $ 18,183 |
| Loans: | | | | | | | |
| Ending balance | $ 131,943 | $ 612,379 | $ 32,157 | $ 365,989 | $ 3,854 | $ 12,561 | $ 1,158,883 |
| Ending balance: Individually evaluated for impairment | $ 600 | $ 6,398 | $ 3,952 | $ 15,866 | $ - | $ - | $ 26,816 |
| Ending balance: Collectively evaluated for impairment | $ 131,343 | $ 605,981 | $ 28,205 | $ 350,123 | $ 3,854 | $ 12,561 | $ 1,132,067 |

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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 June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| Other real estate owned | 2016 | 2015 | 2016 | 2015 |
| Balance at beginning of period | $ 17,745 | $ 35,461 | $ 19,141 | $ 31,982 |
| Property additions | 586 | 907 | 968 | 7,015 |
| Property improvements | - | - | 12 | - |
| Less: | | | | |
| Property disposals, net of gains/losses | 1,590 | 2,316 | 2,929 | 4,336 |
| Period valuation adjustments | 489 | 2,088 | 940 | 2,697 |
| Balance at end of period | $ 16,252 | $ 31,964 | $ 16,252 | $ 31,964 |

Activity in the valuation allowance was as follows:

| | 2016 | 2015 | 2016 | 2015 |
|---|---|---|---|---|
| Balance at beginning of period | $ 14,399 | $ 19,456 | $ 14,127 | $ 19,229 |
| Provision for unrealized losses | 489 | 2,088 | 940 | 2,697 |
| Reductions taken on sales | (1,511) | (1,568) | (1,690) | (1,950) |
| Other adjustments | - | 93 | - | 93 |
| Balance at end of period | $ 13,377 | $ 20,069 | $ 13,377 | $ 20,069 |

Expenses related to OREO, net of lease revenue includes:

| | 2016 | 2015 | 2016 | 2015 |
|---|---|---|---|---|
| Gain on sales, net | $ (25) | $ (242) | $ (67) | $ (337) |
| Provision for unrealized losses | 489 | 2,088 | 940 | 2,697 |
| Operating expenses | 420 | 749 | 856 | 1,750 |
| Less: | | | | |
| Lease revenue | 5 | 207 | 112 | 370 |
| Net OREO expense | $ 879 | $ 2,388 | $ 1,617 | $ 3,740 |

Note 6 – Deposits

Major classifications of deposits were as follows:

| | June 30, 2016 | December 31, 2015 |
|---|---|---|
| Noninterest bearing demand | $ 477,883 | $ 442,639 |
| Savings | 258,269 | 252,169 |
| NOW accounts | 378,622 | 376,720 |
| Money market accounts | 265,685 | 279,709 |
| Certificates of deposit of less than $100,000 | 231,862 | 235,336 |
| Certificates of deposit of $100,000 through $250,000 | 108,047 | 109,855 |
| Certificates of deposit of more than $250,000 | 61,757 | 62,658 |
| Total deposits | $ 1,782,125 | $ 1,759,086 |

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Note 7 – Borrowings

The following table is a summary of borrowings as of June 30, 2016, and December 31, 2015. Junior subordinated debentures are discussed in detail in Note 8:

| | June 30, 2016 | December 31, 2015 |
|---|---|---|
| Securities sold under repurchase agreements | $ 43,138 | $ 34,070 |
| FHLBC advances1 | 50,000 | 15,000 |
| Junior subordinated debentures | 57,567 | 57,543 |
| Subordinated debt | 45,000 | 45,000 |
| Notes payable and other borrowings | 500 | 500 |
| Total borrowings | $ 196,205 | $ 152,113 |

1 Included in other short-term borrowings on the balance sheet.

The Company enters into deposit sweep transactions where the transaction amounts are secured by pledged securities. These transactions consistently mature overnight from the transaction date and are governed by sweep repurchase agreements. All sweep repurchase agreements are treated as financings secured by U.S. government agencies and collateralized mortgage-backed securities and had a carrying amount of $43.1 million at June 30, 2016, and $34.1 million at December 31, 2015. The fair value of the pledged collateral was $48.4 million at June 30, 2016 and $45.4 million at December 31, 2015. At June 30, 2016, there was one customer 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 June 30, 2016, the Bank had taken an advance of $50.0 million on the FHLBC stock valued at $3.2 million, collateralized by securities with a fair value of $132.4 million and loans with a principal balance of $169.2 million, which carried a FHLBC calculated combined collateral value of $237.7 million. The Company had excess collateral of $186.4 million available to secure borrowings at June 30, 2016.

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 both June 30, 2016, and December 31, 2015. 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 June 30, 2016, and December 31, 2015, the Company was in compliance with all covenants contained within the credit 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.

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 Old Second

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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.

Both of the debentures issued by the Company are disclosed on the Consolidated Balance Sheet as junior subordinated debentures and the related interest expense for each issuance is included in the Consolidated Statements of Income. As of June 30, 2016, the Company is current on the payments due on these securities.

Note 9 – Equity Compensation Plans

Stock-based awards are 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; a maximum of 375,000 shares were authorized to be issued under this plan. Following approval of the 2014 Plan, no further awards will be granted under the 2008 Plan or any other Company equity compensation plan. At the May 2016 annual stockholders meeting, an amendment to the 2014 Plan authorized an additional 600,000 shares to be issued, which resulted in a total of 975,000 shares authorized for issuance under this plan. The 2014 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 June 30, 2016, 604,507 shares remained available for issuance under the 2014 Plan.

Total compensation cost that has been charged for the Plans was $325,000 in the first six months of 2016.

There were no stock options granted in the second quarter of 2016 and 2015. All stock options are granted for a term of ten years. There were no stock options exercised during the second quarter of 2016 and 2015 or for the first half of 2016 and 2015. 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 six months ending June 30, 2016, is as follows:

| | Shares | Weighted Average Exercise Price | Weighted-Average Remaining Contractual Term (years) | Aggregate Intrinsic Value |
|---|---|---|---|---|
| Beginning outstanding | 162,500 | $ 27.03 | | |
| Canceled | - | - | | |
| Expired | - | - | | |
| Ending outstanding | 162,500 | $ 27.03 | 1.1 | $ - |
| Exercisable at end of period | 162,500 | $ 27.03 | 1.1 | $ - |

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.

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, but do not entitle holders to voting rights until the restricted period ends and shares are transferred in connection with the units.

There were 120,000 restricted awards issued under the Plans during the six months ending June 30, 2016.  There were 101,500 restricted awards issued during the six months ending June 30, 2015.  Compensation expense is recognized over the vesting period of the restricted award based on the market value of the award on the issue date.

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A summary of changes in the Company's unvested restricted awards for the six months ending June 30, 2016, is as follows:

| | June 30, 2016 | |
|---|---|---|
| | Restricted Stock Shares and Units | Weighted Average Grant Date Fair Value |
| Nonvested at January 1 | 348,000 | $ 4.50 |
| Granted | 120,000 | 6.81 |
| Vested | (105,500) | 3.28 |
| Forfeited | - | - |
| Nonvested at June 30 | 362,500 | $ 5.62 |

Total unrecognized compensation cost of restricted awards was $1.2 million as of June 30, 2016, which is expected to be recognized over a weighted-average period of 2.16 years. Total unrecognized compensation cost of restricted awards was $989,000 as of June 30, 2015, which was expected to be recognized over a weighted-average period of 2.35 years.

Note 10 – Earnings Per Share

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

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2016 | 2015 | 2016 | 2015 |
| Basic earnings per share: | | | | |
| Weighted-average common shares outstanding | 29,535,915 | 29,475,682 | 29,509,672 | 29,473,004 |
| Net income | $ 3,845 | $ 4,129 | $ 7,167 | $ 7,628 |
| Preferred stock dividends and accretion | - | 710 | - | 1,534 |
| Net earnings available to common stockholders | $ 3,845 | $ 3,419 | $ 7,167 | $ 6,094 |
| Basic earnings per share | $ 0.13 | $ 0.12 | $ 0.24 | $ 0.21 |
| Diluted earnings per share: | | | | |
| Weighted-average common shares outstanding | 29,535,915 | 29,475,682 | 29,509,672 | 29,473,004 |
| Dilutive effect of nonvested restricted awards1 | 305,324 | 271,571 | 313,832 | 239,948 |

| | | | | |
|---|---|---|---|---|
| Diluted average common shares outstanding | 29,841,239 | 29,747,253 | 29,823,504 | 29,712,952 |
| Net earnings available to common stockholders | $ 3,845 | $ 3,419 | $ 7,167 | $ 6,094 |
| Diluted earnings per share | $ 0.13 | $ 0.12 | $ 0.24 | $ 0.21 |
| | | | | |
| Number of antidilutive options and warrants excluded from the diluted earnings per share calculation | 977,839 | 1,044,339 | 977,839 | 1,044,339 |

1 Includes the common stock equivalents for restricted share rights that are dilutive.

The above earnings per share calculation did not include a warrant for 815,339 shares of common stock, at an exercise price of $13.43 per share, that was outstanding as of June 30, 2016, and June 30, 2015, because the warrant was anti-dilutive. Of note, the ten year warrant was issued in 2009, and was sold at auction by the Treasury in June 2013 to a third party investor.

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%). At June 30, 2016, the Bank exceeded those thresholds.

At June 30, 2016, the Bank's Tier 1 capital leverage ratio was 10.26%, an increase of 32 basis points from December 31, 2015, and well above the 8.00% objective. The Bank's total capital ratio was 15.74%, an increase of 51 basis points from December 31, 2015, and also well above the objective of 12.00%.

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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 June 30, 2016, and December 31, 2015.

In July 2013, the U.S. federal banking authorities issued final rules (the “Basel III Rules”) establishing more stringent regulatory capital requirements for U.S. banking institutions, which went into effect on January 1, 2015. A detailed discussion of the Basel III Rules is included in Part I, Item 1 of the Company’s Form 10-K for the year ended December 31, 2015, under the heading “Supervision and Regulation.”

At June 30, 2016, the Company, on a consolidated basis, exceeded the minimum thresholds to be considered “adequately capitalized” under current regulatory defined capital ratios.

Capital levels and industry defined regulatory minimum required levels are as follows:

| | Actual | | Minimum Capital Adequacy with Capital Conservation Buffer if applicable | | To Be Well Capitalized Under Prompt Corrective Action Provisions1 | |
|---|---|---|---|---|---|---|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| June 30, 2016 | | | | | | |
| Common equity tier 1 capital to risk weighted assets | | | | | | |
| Consolidated | $ 152,617 | 10.30% | $ 75,938 | 5.125% | N/A | N/A |
| Old Second Bank | 216,498 | 14.67 | 75,634 | 5.125 | $ 95,926 | 6.50 % |
| Total capital to risk weighted assets | | | | | | |
| Consolidated | 222,649 | 15.03 | 127,768 | 8.625 | N/A | N/A |
| Old Second Bank | 232,315 | 15.74 | 127,301 | 8.625 | 147,595 | 10.00 |
| Tier 1 capital to risk weighted assets | | | | | | |
| Consolidated | 188,276 | 12.71 | 98,138 | 6.625 | N/A | N/A |
| Old Second Bank | 216,498 | 14.67 | 97,771 | 6.625 | 118,063 | 8.00 |
| Tier 1 capital to average assets | | | | | | |
| Consolidated | 188,276 | 8.94 | 84,240 | 4.00 | N/A | N/A |
| Old Second Bank | 216,498 | 10.26 | 84,405 | 4.00 | 105,506 | 5.00 |
| | | | | | | |
| December 31, 2015 | | | | | | |

| | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| Common equity tier 1 capital to risk weighted assets | | | | | | | | | | |
| Consolidated | $ | 151,410 | 10.55 % | $ | 64,582 | 4.50 % | | N/A | N/A | |
| Old Second Bank | | 202,158 | 14.10 | | 64,519 | 4.50 | $ | 93,193 | 6.50 | % |
| Total capital to risk weighted assets | | | | | | | | | | |
| Consolidated | | 223,311 | 15.56 | | 114,813 | 8.00 | | N/A | N/A | |
| Old Second Bank | | 218,375 | 15.23 | | 114,708 | 8.00 | | 143,385 | 10.00 | |
| Tier 1 capital to risk weighted assets | | | | | | | | | | |
| Consolidated | | 176,625 | 12.30 | | 86,159 | 6.00 | | N/A | N/A | |
| Old Second Bank | | 202,158 | 14.10 | | 86,025 | 6.00 | | 114,700 | 8.00 | |
| Tier 1 capital to average assets | | | | | | | | | | |
| Consolidated | | 176,625 | 8.69 | | 81,300 | 4.00 | | N/A | N/A | |
| Old Second Bank | | 202,158 | 9.94 | | 81,351 | 4.00 | | 101,689 | 5.00 | |

1 The Bank exceeded the general minimum regulatory requirements to be considered “well capitalized.”

Dividend Restrictions

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.  Pursuant to the Basel III rules that came into effect January 1, 2015, the Bank must keep a buffer of 0.625% for 2016, 1.25% for 2017, 1.875% for 2018, and 2.5% for 2019 and thereafter of minimum capital requirements in order to avoid additional limitations on capital distributions.

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Note 12 – 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 six months ended June 30, 2016, there were no significant transfers between levels. For the six months ended June 30, 2015, there was a transfer of $24.9 million from Level 3 to Level 2 in 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 spreads, market valuations of like securities, like securities 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.
- Auction rate securities are priced using market spreads, cash flows, prepayment speeds, and loss analytics. Therefore, the valuations of auction rate asset-backed securities were transferred to Level 2 valuations.
- Asset-backed collateralized loan obligations were priced using data from a pricing matrix supported by our bond accounting service provider and are therefore considered Level 2 valuations.
- Annually every security holding is priced by a pricing service independent of the regular and recurring pricing services used. The independent service provides a measurement to indicate if the price assigned by the regular service is within or outside of a reasonable range. Management reviews this report and applies judgment in adjusting calculations, usually in the last quarter of the year, related to securities pricing.
- 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 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.
- The fair value of impaired loans with specific allocations of the allowance for loan losses is essentially based on recent real estate appraisals or the fair value of the collateralized asset. 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

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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 June 30, 2016, and December 31, 2015, respectively, measured by the Company at fair value on a recurring basis:

| | June 30, 2016 | | | |
|---|---|---|---|---|
| | Level 1 | Level 2 | Level 3 | Total |
| Assets: | | | | |
| Securities available-for-sale | | | | |
| U.S. government agencies | $ - | $ 1,522 | $ - | $ 1,522 |
| U.S. government agencies mortgage-backed | - | 43,646 | - | 43,646 |
| States and political subdivisions | - | 42,621 | - | 42,621 |
| Corporate bonds | - | 30,208 | - | 30,208 |
| Collateralized mortgage obligations | - | 289,225 | - | 289,225 |
| Asset-backed securities | - | 250,959 | - | 250,959 |
| Collateralized loan obligations | - | 106,370 | - | 106,370 |
| Loans held-for-sale | - | 5,589 | - | 5,589 |
| Mortgage servicing rights | - | - | 4,698 | 4,698 |
| Other assets (Interest rate swap agreements) | - | 668 | - | 668 |
| Other assets (Mortgage banking derivatives) | - | 328 | - | 328 |
| Total | $ - | $ 771,136 | $ 4,698 | $ 775,834 |
| | | | | |
| Liabilities: | | | | |
| Other liabilities (Interest rate swap agreements) | $ - | $ 5,323 | $ - | $ 5,323 |
| Total | $ - | $ 5,323 | $ - | $ 5,323 |

| | December 31, 2015 | | | |
|---|---|---|---|---|
| | Level 1 | Level 2 | Level 3 | Total |
| Assets: | | | | |
| Securities available-for-sale | | | | |
| U.S. Treasury | $ 1,509 | $ - | $ - | $ 1,509 |

| | | | | |
|---|---|---|---|---|
| U.S. government agencies | - | 1,556 | - | 1,556 |
| U.S. government agencies mortgage-backed | - | 1,996 | - | 1,996 |
| States and political subdivisions | - | 30,415 | 111 | 30,526 |
| Corporate bonds | - | 29,400 | - | 29,400 |
| Collateralized mortgage obligations | - | 66,920 | - | 66,920 |
| Asset-backed securities | - | 231,908 | - | 231,908 |
| Collateralized loan obligations | - | 92,251 | - | 92,251 |
| Loans held-for-sale | - | 2,849 | - | 2,849 |
| Mortgage servicing rights | - | - | 5,847 | 5,847 |
| Other assets (Interest rate swap agreements net of swap credit valuation) | - | 114 | - | 114 |
| Other assets (Mortgage banking derivatives) | - | 188 | - | 188 |
| Total | $ 1,509 | $ 457,597 | $ 5,958 | $ 465,064 |
| | | | | |
| Liabilities: | | | | |
| Other liabilities (Interest rate swap agreements) | $ - | $ 745 | $ - | $ 745 |
| Total | $ - | $ 745 | $ - | $ 745 |

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The significant increase in the total assets measured at fair value on a recurring basis is primarily due to the transfer of securities held-to-maturity to securities available-for-sale in the second quarter of 2016.

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

| | Six Months Ended June 30, 2016 | |
|---|---|---|
| | Securities available-for-sale | |
| | States and Political Subdivisions | Mortgage Servicing Rights |
| Beginning balance January 1, 2016 | $ 111 | $ 5,847 |
| Transfers out of Level 3 | (42) | - |
| Total gains or losses | | |
| Included in earnings (or changes in net assets) | - | (1,464) |
| Included in other comprehensive income | 9 | - |
| Purchases, issuances, sales, and settlements | | |
| Issuances | - | 625 |
| Settlements | (78) | (310) |
| Sales | - | - |
| Ending balance June 30, 2016 | $ - | $ 4,698 |

| | Six Months Ended June 30, 2015 | | |
|---|---|---|---|
| | Securities available-for-sale | | |
| | Asset-backed | States and Political Subdivisions | Mortgage Servicing Rights |
| Beginning balance January 1, 2015 | $ 52,941 | $ 118 | $ 5,462 |
| Transfers out of Level 3 | (24,917) | - | - |
| Total gains or losses | | | |
| Included in earnings (or changes in net assets) | (28) | - | (137) |
| Included in other comprehensive income | (541) | - | - |
| Purchases, issuances, sales, and settlements | | | |
| Issuances | - | - | 935 |
| Settlements | - | - | (376) |
| Sales | (27,455) | - | - |
| Ending balance June 30, 2015 | $ - | $ 118 | $ 5,884 |

The following table and commentary presents quantitative and qualitative information about Level 3 fair value measurements as of June 30, 2016:

| Measured at fair value on a recurring basis: | Fair Value | Valuation Methodology | Unobservable Inputs | Range of Input | Weighted Average of Inputs |
|---|---|---|---|---|---|
| Mortgage Servicing rights | $ 4,698 | Discounted Cash Flow | Discount Rate | 10.0-17.0% | 10.2 % |
| | | | Prepayment Speed | 6.0-39.3% | 15.3 % |

The following table and commentary presents quantitative and qualitative information about Level 3 fair value measurements as of December 31, 2015:

| Measured at fair value on a recurring basis: | Fair Value | Valuation Methodology | Unobservable Inputs | Range of Input | Weighted Average of Inputs |
|---|---|---|---|---|---|
| Mortgage Servicing rights | $ 5,847 | Discounted Cash Flow | Discount Rate | 10.0-15.5% | 10.2 % |
| | | | Prepayment Speed | 6.0-35.2% | 10.1 % |

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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 June 30, 2016, and December 31, 2015, respectively, the following tables provide the level of valuation assumptions used to determine each valuation and the carrying value of the related assets:

| | June 30, 2016 | | | |
|---|---|---|---|---|
| | Level 1 | Level 2 | Level 3 | Total |
| Impaired loans1 | $ - | $ - | $ 1,836 | $ 1,836 |
| Other real estate owned, net2 | - | - | 16,252 | 16,252 |
| Total | $ - | $ - | $ 18,088 | $ 18,088 |

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 $2.6 million, with a valuation allowance of $758,000 resulting in an increase of specific allocations within the allowance for loan losses of $724,000 for the six months ending June 30, 2016.

2 OREO is measured at the lower of carrying or fair value less costs to sell, and had a net carrying amount of $16.3 million, which is made up of the outstanding balance of $31.3 million, net of a valuation allowance of $13.4 million and participations of $1.7 million, at June 30, 2016.

| | December 31, 2015 | | | |
|---|---|---|---|---|
| | Level 1 | Level 2 | Level 3 | Total |
| Impaired loans1 | $ - | $ - | $ 81 | $ 81 |
| Other real estate owned, net2 | - | - | 19,141 | 19,141 |
| Total | $ - | $ - | $ 19,222 | $ 19,222 |

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 $115,000, with a valuation allowance of $34,000, resulting in a decrease of specific allocations within the provision for loan losses of $243,000 for the year ending December 31, 2015.

2 OREO is measured at the lower of carrying or fair value less costs to sell, and had a net carrying amount of $19.1 million, which is made up of the outstanding balance of $34.9 million, net of a valuation allowance of

$14.1 million and participations of $1.7 million, at December 31, 2015.

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 – Fair Values of Financial Instruments

The estimated fair values approximate carrying amount for all items except those described in the following table. Securities available-for-sale 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. FHLBC stock is carried at cost and considered a Level 2 fair value. 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.

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

| | June 30, 2016 | | | | |
|---|---|---|---|---|---|
| | Carrying Amount | Fair Value | Level 1 | Level 2 | Level 3 |
| Financial assets: | | | | | |
| Cash and due from banks | $ 32,806 | $ 32,806 | $ 32,806 | $ - | $ - |
| Interest bearing deposits with financial institutions | 7,525 | 7,525 | 7,525 | - | - |
| Securities available-for-sale | 764,551 | 764,551 | - | 764,551 | - |
| FHLBC and Reserve Bank Stock | 7,918 | 7,918 | - | 7,918 | - |
| Loans held-for-sale | 5,589 | 5,589 | - | 5,589 | - |
| Loans, net | 1,145,329 | 1,154,760 | - | - | 1,154,760 |
| Accrued interest receivable | 4,677 | 4,677 | - | 4,677 | - |
| Financial liabilities: | | | | | |
| Noninterest bearing deposits | $ 477,883 | $ 477,883 | $ 477,883 | $ - | $ - |
| Interest bearing deposits | 1,304,242 | 1,307,460 | - | 1,307,460 | - |
| Securities sold under repurchase agreements | 43,138 | 43,138 | - | 43,138 | - |
| Other short-term borrowings | 50,000 | 50,000 | - | 50,000 | - |
| Junior subordinated debentures | 57,567 | 56,226 | 33,354 | 22,872 | - |
| Subordinated debenture | 45,000 | 42,109 | - | 42,109 | - |
| Note payable and other borrowings | 500 | 459 | - | 459 | - |
| Interest rate swap agreements | 4,655 | 4,655 | | 4,655 | |
| Borrowing interest payable | 86 | 86 | - | 86 | - |
| Deposit interest payable | 467 | 467 | - | 467 | - |

| | December 31, 2015 | | | | |
|---|---|---|---|---|---|
| | Carrying Amount | Fair Value | Level 1 | Level 2 | Level 3 |
| Financial assets: | | | | | |
| Cash and due from banks | $ 26,975 | $ 26,975 | $ 26,975 | $ - | $ - |
| Interest bearing deposits with financial institutions | 13,363 | 13,363 | 13,363 | - | - |
| Securities available-for-sale | 456,066 | 456,066 | 1,509 | 454,446 | 111 |
| Securities held-to-maturity | 247,746 | 251,675 | - | 251,675 | - |
| FHLBC and Reserve Bank Stock | 8,518 | 8,518 | - | 8,518 | - |
| Loans held-for-sale | 2,849 | 2,849 | - | 2,849 | - |
| Loans, net | 1,117,492 | 1,126,959 | - | - | 1,126,959 |
| Accrued interest receivable | 4,464 | 4,464 | - | 4,464 | - |

| | | | | | |
|---|---|---|---|---|---|
| Financial liabilities: | | | | | |
| Noninterest bearing deposits | $ 442,639 | $ 442,639 | $ 442,639 | $ - | $ - |
| Interest bearing deposits | 1,316,447 | 1,316,550 | - | 1,316,550 | - |
| Securities sold under repurchase agreements | 34,070 | 34,070 | - | 34,070 | - |
| Other short-term borrowings | 15,000 | 15,000 | - | 15,000 | - |
| Junior subordinated debentures | 57,543 | 53,851 | 31,606 | 22,245 | - |
| Subordinated debenture | 45,000 | 41,101 | - | 41,101 | - |
| Note payable and other borrowings | 500 | 445 | - | 445 | - |
| Interest rate swap agreements | 631 | 631 | | 631 | |
| Borrowing interest payable | 75 | 75 | - | 75 | - |
| Deposit interest payable | 445 | 445 | - | 445 | - |

Note 14 – 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.

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Interest Rate Swap Designated as a Cash Flow Hedge

The Company entered into a forward starting interest rate swap on August 18, 2015, with an effective date of June 15, 2017. This transaction had a notional amount totaling $25.8 million as of June 30, 2016, was designated as a cash flow hedge of certain junior subordinated debentures and was determined to be fully effective during the period presented. As such, no amount of ineffectiveness has been included in net income. Therefore, the aggregate fair value of the swap is recorded in other assets with changes in fair value recorded in other comprehensive income. The amount included in other comprehensive income would be reclassified to current earnings should all or a portion of the hedge no longer be considered effective. The Company expects the hedge to remain fully effective during the remaining term of the swap. The Bank will pay the counterparty a fixed rate and receive a floating rate based on three month LIBOR. Management concluded that it would be advantageous to enter this transaction given that the Company has trust preferred securities that will change from fixed rate to floating rate on June 15, 2017. The cash flow hedge has a maturity date of June 15, 2037.

Summary information about the interest rate swap designated as a cash flow hedge is as follows:

| | As of June 30, 2016 | December 31, 2015 |
|---|---|---|
| Notional amount | $ 25,774 | $ 25,774 |
| Unrealized loss | (4,655) | (631) |

Other 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. Per contractual requirements with the correspondent financial institution, the Bank had $7.2 million in securities available-for-sale pledged to support interest rate swap activity with two correspondent financial institutions at June 30, 2016. The Bank had $2.4 million in securities pledged to support interest rate swap activity with two correspondent financial institutions at December 31, 2015.

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 June 30, 2016, the notional amount of non-hedging interest rate swaps was $35.7 million with a weighted average maturity of 5.2 years. At December 31, 2015, the notional amount of non-hedging interest rate swaps was $20.7 million with a weighted average maturity of 5.1 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 June 30, 2016, 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.

| | | Asset Derivatives | | Liability Derivatives | |
|---|---|---|---|---|---|
| | Notional or Contractual Amount | Balance Sheet Location | Fair Value | Balance Sheet Location | Fair Value |
| Interest rate swap contracts | $ 35,700 | Other Assets | $ 668 | Other Liabilities | $ 668 |
| Commitments1 | 249,885 | Other Assets | 328 | N/A | - |
| Forward contracts2 | 27,000 | N/A | - | Other Liabilities | - |
| Total | | | $ 996 | | $ 668 |

1Includes unused loan commitments and interest rate lock commitments.

2Includes forward MBS contracts and forward loan contracts.

The following table presents derivatives not designated as hedging instruments as of December 31, 2015.

| | | Asset Derivatives | | Liability Derivatives | |
|---|---|---|---|---|---|
| | Notional or Contractual Amount | Balance Sheet Location | Fair Value | Balance Sheet Location | Fair Value |
| Interest rate swap contracts net of credit valuation | $ 20,708 | Other Assets | $ 114 | Other Liabilities | $ 114 |
| Commitments1 | 226,346 | Other Assets | 188 | N/A | - |
| Forward contracts2 | 15,500 | N/A | - | Other Liabilities | |