

OLD SECOND BANCORP INC

Form 10-Q

November 14, 2012

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**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

x                    **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF**  
                         **THE SECURITIES EXCHANGE ACT OF 1934**  
                         For the quarterly period ended September 30, 2012  
                         OR  
o                    **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE**  
                         **SECURITIES EXCHANGE ACT OF 1934**

For transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number 0 -10537

**OLD SECOND BANCORP, INC.**

(Exact name of Registrant as specified in its charter)

**Delaware**

(State or other jurisdiction  
of incorporation or organization)

**36-3143493**

(I.R.S. Employer Identification Number)

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

(Address of principal executive offices) (Zip Code)

**(630) 892-0202**

(Registrant's telephone number, including area code)

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

Yes ☒ No ☐

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

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

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

Indicate by check mark whether the registrant is a shell company (as defined in Exchange Act Rule 12b-2).

Yes ☐ No ☒

Indicate the number of shares outstanding of each of the issuer's classes of common stock as of the latest practicable date: As of November 9, 2012, the Registrant had outstanding 14,084,328 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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Table of Contents**PART I - FINANCIAL INFORMATION****Item 1. Financial Statements****Old Second Bancorp, Inc. and Subsidiaries****Consolidated Balance Sheets***(In thousands, except share data)*

	(Unaudited) September 30, 2012	December 31, 2011
<b>Assets</b>		
Cash and due from banks	\$ 38,185	\$ 2,692
Interest bearing deposits with financial institutions	34,056	48,257
Cash and cash equivalents	72,241	50,949
Securities available-for-sale	412,346	307,564
Federal Home Loan Bank and Federal Reserve Bank stock	11,800	14,050
Loans held-for-sale	5,032	12,806
Loans	1,208,289	1,368,985
Less: allowance for loan losses	40,257	51,997
Net loans	1,168,032	1,316,988
Premises and equipment, net	48,509	50,477
Other real estate owned	88,093	93,290
Mortgage servicing rights, net	3,603	3,487
Core deposit intangible assets, net	3,813	4,678
Bank-owned life insurance (BOLI)	53,841	52,595
Other assets	36,090	34,534
Total assets	\$ 1,903,400	\$ 1,941,418
<b>Liabilities</b>		
Deposits:		
Noninterest bearing demand	\$ 381,111	\$ 361,963
Interest bearing:		
Savings, NOW, and money market	798,281	761,335
Time	517,542	617,483
Total deposits	1,696,934	1,740,781
Securities sold under repurchase agreements	1,738	901
Junior subordinated debentures	58,378	58,378
Subordinated debt	45,000	45,000
Notes payable and other borrowings	500	500
Other liabilities	30,109	21,856
Total liabilities	1,832,659	1,867,416
<b>Stockholders' Equity</b>		
Preferred stock	71,611	70,863
Common stock	18,729	18,628
Additional paid-in capital	66,118	65,999

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Retained earnings	11,795	17,107
Accumulated other comprehensive loss	(2,556)	(3,702)
Treasury stock	(94,956)	(94,893)
Total stockholders' equity	70,741	74,002
Total liabilities and stockholders' equity	\$ 1,903,400	\$ 1,941,418

	September 30, 2012		December 31, 2011	
	Preferred Stock	Common Stock	Preferred Stock	Common Stock
Par value	\$ 1	\$ 1	\$ 1	\$ 1
Liquidation value	1,000	n/a	1,000	n/a
Shares authorized	300,000	60,000,000	300,000	60,000,000
Shares issued	73,000	18,729,134	73,000	18,627,858
Shares outstanding	73,000	14,084,328	73,000	14,034,991
Treasury shares	-	4,644,806	-	4,592,867

See accompanying notes to consolidated financial statements.

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

(In thousands, except share data)

	(unaudited) Three Months Ended September 30,		(unaudited) Nine Months Ended September 30,	
	2012	2011	2012	2011
<b>Interest and Dividend Income</b>				
Loans, including fees	\$ 16,193	\$ 19,800	\$ 51,476	\$ 61,765
Loans held-for-sale	68	72	201	198
Securities:				
Taxable	1,868	928	5,222	2,691
Tax exempt	98	114	303	383
Dividends from Federal Reserve Bank and Federal Home Loan Bank stock	77	73	228	216
Federal funds sold	-	-	-	1
Interest bearing deposits with financial institutions	29	58	89	197
Total interest and dividend income	18,333	21,045	57,519	65,451
<b>Interest Expense</b>				
Savings, NOW, and money market deposits	253	327	807	1,275
Time deposits	1,973	3,436	6,920	11,220
Securities sold under repurchase agreements	1	-	2	-
Other short-term borrowings	-	-	4	-
Junior subordinated debentures	1,243	1,155	3,660	3,401
Subordinated debt	223	201	684	610
Notes payable and other borrowings	5	4	13	12
Total interest expense	3,698	5,123	12,090	16,518
Net interest and dividend income	14,635	15,922	45,429	48,933
Provision for loan losses	-	3,000	6,284	7,500
Net interest and dividend income after provision for loan losses	14,635	12,922	39,145	41,433
<b>Noninterest Income</b>				
Trust income	1,489	1,657	4,603	5,156
Service charges on deposits	1,982	2,157	5,706	6,021
Secondary mortgage fees	350	269	957	732
Mortgage servicing income, net of changes in fair value	(155)	(328)	(365)	(221)
Net gain on sales of mortgage loans	2,504	1,314	7,509	3,667
Securities gains (losses), net	513	(63)	1,306	588
Increase in cash surrender value of bank-owned life insurance	425	233	1,246	1,130
Debit card interchange income	788	775	2,661	2,259
Lease revenue from other real estate owned	840	1,060	2,930	2,537
Net gain on sale of other real estate owned	20	297	398	933
Other income	1,592	1,137	4,257	4,044
Total noninterest income	10,348	8,508	31,208	26,846
<b>Noninterest Expense</b>				
Salaries and employee benefits	8,963	7,985	26,835	25,494
Occupancy expense, net	1,242	1,273	3,684	3,928
Furniture and equipment expense	1,078	1,405	3,416	4,340
FDIC insurance	1,029	1,032	3,058	3,884
General bank insurance	851	845	2,538	2,496
Amortization of core deposit and other intangible asset	420	276	865	711
Advertising expense	400	311	982	731
Debit card interchange expense	388	394	1,183	1,091
Legal fees	760	924	2,215	2,907
Other real estate expense	6,545	5,353	17,987	16,618
Other expense	3,187	3,022	9,186	9,576
Total noninterest expense	24,863	22,820	71,949	71,776

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Income (loss) before income taxes	120	(1,390)	(1,596)	(3,497)
Income taxes	-	-	-	-
<b>Net Income (loss)</b>	<b>\$ 120</b>	<b>\$ (1,390)</b>	<b>\$ (1,596)</b>	<b>\$ (3,497)</b>
Preferred stock dividends and accretion	1,255	1,190	3,716	3,524
<b>Net loss available to common stockholders</b>	<b>\$ (1,135)</b>	<b>\$ (2,580)</b>	<b>\$ (5,312)</b>	<b>\$ (7,021)</b>
Basic loss per share	\$ (0.08)	\$ (0.18)	\$ (0.37)	\$ (0.49)
Diluted loss per share	(0.08)	(0.18)	(0.37)	(0.49)
Dividends declared per share	-	-	-	-

See accompanying notes to consolidated financial statements.

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

(In thousands, except share data)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Net income (loss)	\$ 120	\$ (1,390)	\$ (1,596)	\$ (3,497)
Total unrealized holding gains (loss) on available-for-sale securities arising during the period	2,908	(962)	3,255	500
Related tax (expense) benefit	(1,194)	396	(1,335)	(130)
Holding income (loss) after tax	1,714	(566)	1,920	370
Less: Reclassification adjustment for the net gains and losses realized during the period				
Net realized gains (losses)	513	(63)	1,306	588
Income tax (expense) benefit on net realized gains	(208)	25	(532)	(241)
Net realized gains (losses) after tax	305	(38)	774	347
Total other comprehensive income (loss)	1,409	(528)	1,146	23
Comprehensive income (loss)	\$ 1,529	\$ (1,918)	\$ (450)	\$ (3,474)

See accompanying notes to consolidated financial statements.



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

(In thousands)

	(Unaudited) Nine Months Ended September 30,	
	2012	2011
<b>Cash flows from operating activities</b>		
Net loss	\$ (1,596)	\$ (3,497)
Adjustments to reconcile net loss to net cash provided by operating activities:		
Depreciation and amortization of leasehold improvement	2,339	3,160
Change in market value of mortgage servicing rights	1,315	1,144
Provision for loan losses	6,284	7,500
Originations of loans held-for-sale	(208,710)	(152,925)
Proceeds from sales of loans held-for-sale	222,590	157,276
Net gain on sales of mortgage loans	(7,509)	(3,667)
Change in current income taxes receivable	815	5,749
Increase in cash surrender value of bank-owned life insurance	(1,246)	(1,130)
Change in accrued interest receivable and other assets	(2,437)	(1,681)
Change in accrued interest payable and other liabilities	4,689	(365)
Net premium amortization on securities	664	117
Securities gains, net	(1,306)	(588)
Amortization of core deposit and other intangible assets	865	711
Stock based compensation	220	666
Net gain on sale of other real estate owned	(398)	(933)
Write-down of other real estate owned expensed	12,101	9,153
Net cash provided by operating activities	28,680	20,690
<b>Cash flows from investing activities</b>		
Proceeds from maturities and pre-refunds including pay down of securities available-for-sale	65,940	38,384
Proceeds from sales of securities available-for-sale	185,861	15,277
Purchases of securities available-for-sale	(353,992)	(92,818)
Net sales (purchases) of Federal Reserve Bank and Federal Home Loan Bank stock	2,250	(359)
Net change in loans	115,728	181,861
Investment in other real estate owned	(646)	(2,561)
Proceeds from sales of other real estate owned	20,915	29,687
Net purchases of premises and equipment	(371)	(492)
Net cash provided by investing activities	35,685	168,979
<b>Cash flows from financing activities</b>		
Net change in deposits	(43,847)	(180,494)
Net change in securities sold under repurchase agreements	837	613
Net change in other short-term borrowings	-	174
Purchase of treasury stock	(63)	(49)
Net cash used in financing activities	(43,073)	(179,756)
Net change in cash and cash equivalents	21,292	9,913
Cash and cash equivalents at beginning of period	50,949	98,758
Cash and cash equivalents at end of period	\$ 72,241	\$ 108,671
<b>Supplemental cash flow information</b>		
Income taxes received	\$ (815)	\$ (5,746)
Interest paid for deposits	8,444	13,268

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Interest paid for borrowings	702	623
Non-cash transfer of loans to other real estate owned	26,944	60,355
Change in dividends declared not paid	2,968	2,823
Accretion on preferred stock warrants	748	701

See accompanying notes to consolidated financial statements.

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

(In thousands, except share data)

	Common Stock	Preferred Stock	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Treasury Stock	Total Stockholders' Equity
Balance, December 31, 2010	\$ 18,467	\$ 69,921	\$ 65,209	\$ 28,335	\$ (3,130)	\$ (94,844)	\$ 83,958
Comprehensive loss:							
Net loss				(3,497)			(3,497)
Change in net unrealized loss on securities available-for-sale net of \$111 tax effect					23		23
Change in restricted stock	161		(161)				-
Stock based compensation			666				666
Purchase of treasury stock						(49)	(49)
Preferred dividends declared and accrued (5% per preferred share)		701		(3,524)			(2,823)
Balance, September 30, 2011	\$ 18,628	\$ 70,622	\$ 65,714	\$ 21,314	\$ (3,107)	\$ (94,893)	\$ 78,278
Balance, December 31, 2011	\$ 18,628	\$ 70,863	\$ 65,999	\$ 17,107	\$ (3,702)	\$ (94,893)	\$ 74,002
Comprehensive loss:							
Net loss				(1,596)			(1,596)
Change in net unrealized gain on securities available-for-sale net of \$803 tax effect					1,146		1,146
Change in restricted stock	101		(101)				-
Stock based compensation			220				220
Purchase of treasury stock						(63)	(63)
Preferred dividends declared and accrued (5% per preferred share)		748		(3,716)			(2,968)
Balance, September 30, 2012	\$ 18,729	\$ 71,611	\$ 66,118	\$ 11,795	\$ (2,556)	\$ (94,956)	\$ 70,741

See accompanying notes to consolidated financial statements.

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

**Notes to Consolidated Financial Statements**

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

**Note 1 Summary of Significant Accounting Policies**

The accounting policies followed in the preparation of the interim financial statements are consistent with those used in the preparation of the annual financial information. The interim financial statements reflect all normal and recurring adjustments, which are necessary, in the opinion of management, for a fair statement of results for the interim period presented. Results for the period ended September 30, 2012, are not necessarily indicative of the results that may be expected for the year ending December 31, 2012. These interim financial statements should be read in conjunction with the audited financial statements and notes included in Old Second Bancorp, Inc.'s (the Company) annual report on Form 10-K for the year ended December 31, 2011. Unless otherwise indicated, amounts in the tables contained in the notes are in thousands. Certain items in prior periods have been reclassified to conform to the current presentation.

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

The Company uses the accrual basis of accounting for financial reporting purposes. Certain reclassifications were made to prior year amounts to conform to the current year presentation.

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, 2011. These policies, along with the disclosures presented in the other financial statement notes and in this discussion, provide information on how significant assets and liabilities are valued in the financial statements and how those values are determined.

In May 2011, the FASB issued ASU No. 2011-04 Fair Value Measurement (Topic 820) - Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs. ASU 2011-04 changes the wording used to describe many of the requirements in GAAP for measuring fair value and for disclosing information about fair value measurements. Consequently, the amendments in this update result in common fair value measurement and disclosure requirements in GAAP and International Financial Reporting Standards. ASU 2011-04 is effective prospectively during interim and annual periods beginning on or after December 15, 2011. The Company has assessed and implemented ASU 2011-04 in its fair value disclosures and found no material impact.

In June 2011, the FASB issued ASU No. 2011-05 Comprehensive Income (Topic 220) - Presentation of Comprehensive Income. ASU 2011-05 requires that all non-owner changes in stockholders' equity be presented either in a single continuous statement of comprehensive income or in

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two separate but consecutive statements. In both choices, an entity is required to present each component of net income along with total net income, each component of other comprehensive income along with a total for other comprehensive income, and a total amount for comprehensive income. Retrospective application of the standard is required. In December 2011, the FASB issued Accounting Standards Update (ASU) No. 2011-12: Comprehensive Income (Topic 220) Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in ASU No. 2011-05, to defer the effective date for the part of ASU No. 2011-05 that would require adjustments of items out of accumulated other income to be presented on the components of both net income and other comprehensive income in financial statements. The Company has included the consolidated statements of

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comprehensive income. There was no impact on the consolidated statements of operations or balance sheets based on the adoption of this standard.

In April 2011, the FASB issued ASU No. 2011-03 Transfers and Servicing (Topic 860) - Reconsideration of Effective Control for Repurchase Agreement. ASU 2011-03 removed from the assessment of effective control the criterion relating to the transferor's ability to repurchase or redeem financial assets on substantially the agreed terms, even in the event of default by the transferee. ASU 2011-03 was effective for the first interim or annual period beginning on or after December 15, 2011. The guidance should be applied prospectively to transactions or modifications of existing transactions that occurred on or after the effective date. Early adoption was not permitted. ASU 2011-03 did not have an impact on the Company's financial condition, results of operations, or liquidity.

**Note 2 Securities**

**Investment Portfolio Management**

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

Portfolio size and composition may 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. All debt securities are classified as available-for-sale and may be sold under our management and asset/liability management strategies. Securities available-for-sale are carried at fair value. Unrealized gains and losses 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.

Non-marketable equity investments include Federal Home Loan Bank of Chicago ( FHLBC ) stock and Federal Reserve Bank of Chicago ( FRB ) stock. FHLBC stock was recorded at a value of \$7.0 million at September 30, 2012, a decrease of \$2.3 million from December 31, 2011. Our FHLBC stock is necessary to maintain our continued access to FHLBC advances. In late 2011, management at the Bank evaluated the October 17, 2011, FHLBC Capital Plan and determined the best overall course for the Bank was to accept the stock conversion as of January 1, 2012. Subsequently, during the first nine months of 2012 management redeemed excess FHLBC stock held by the Bank reducing the value of FHLBC stock held by the Bank to \$7.0 million. FRB stock was recorded at \$4.8 million at September 30, 2012, which was unchanged from December 31, 2011.



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The following table summarizes the amortized cost and fair value of the available-for-sale securities at September 30, 2012 and December 31, 2011 and the corresponding amounts of gross unrealized gains and losses recognized in accumulated other comprehensive loss:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
<b>September 30, 2012:</b>				
U.S. Treasury	\$ 1,500	\$ 11	\$ -	\$ 1,511
U.S. government agencies	49,332	191	(68)	49,455
U.S. government agency mortgage-backed	71,215	2,114	(38)	73,291
States and political subdivisions	11,598	1,207	-	12,805
Corporate Bonds	33,673	562	(18)	34,217
Collateralized mortgage obligations	95,894	1,075	(531)	96,438
Asset-backed securities	135,577	774	(1,265)	135,086
Collateralized debt obligations	17,902	-	(8,359)	9,543
	\$ 416,691	\$ 5,934	\$ (10,279)	\$ 412,346
<b>December 31, 2011:</b>				
U.S. Treasury	\$ 1,501	\$ 23	\$ -	\$ 1,524
U.S. government agencies	43,112	286	-	43,398
U.S. government agency mortgage-backed	152,473	1,553	(19)	154,007
States and political subdivisions	12,152	1,657	-	13,809
Corporate Bonds	32,357	14	(982)	31,389
Collateralized mortgage obligations	25,616	242	(736)	25,122
Asset-backed securities	28,755	-	(414)	28,341
Collateralized debt obligations	17,892	-	(7,918)	9,974
	\$ 313,858	\$ 3,775	\$ (10,069)	\$ 307,564

The fair value, amortized cost and weighted average yield of debt securities at September 30, 2012, by contractual maturity, were as follows. Securities not due at a single maturity date, primarily mortgage-backed securities and collateralized debt obligations are shown separately:

	Amortized Cost	Weighted Average Yield	Fair Value
Due in one year or less	\$ 9,962	2.20%	\$ 10,053
Due after one year through five years	39,755	1.88%	40,543
Due after five years through ten years	12,190	3.43%	13,051
Due after ten years	34,196	3.85%	34,341
	96,103	2.81%	97,988
Mortgage-backed securities	167,109	2.12%	169,729
Asset-back securities	135,577	1.49%	135,086
Collateralized debt obligations	17,902	1.90%	9,543
	\$ 416,691	2.06%	\$ 412,346

Securities with unrealized losses at September 30, 2012, and December 31, 2011, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, are as follows (in thousands except for number of securities):





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September 30, 2012	Less than 12 months in an unrealized loss position			Greater than 12 months in an unrealized loss position			Total		
	Number of Securities	Unrealized Losses	Fair Value	Number of Securities	Unrealized Losses	Fair Value	Number of Securities	Unrealized Losses	Fair Value
U.S. government agencies	2	\$ 68	\$ 13,197		\$ -	\$ -	2	\$ 68	\$ 13,197
U.S. government agency mortgage-backed	1	38	4,099	-	-	-	1	38	4,099
Corporate bonds	1	18	1,075	-	-	-	1	18	1,075
Collateralized mortgage obligations	7	531	38,294	-	-	-	7	531	38,294
Asset-backed securities	11	1,265	78,650	-	-	-	11	1,265	78,650
Collateralized debt obligations	-	-	-	2	8,359	9,543	2	8,359	9,543
	22	\$ 1,920	\$ 135,315	2	\$ 8,359	\$ 9,543	24	\$ 10,279	\$ 144,858

December 31, 2011	Less than 12 months in an unrealized loss position			Greater than 12 months in an unrealized loss position			Total		
	Number of Securities	Unrealized Losses	Fair Value	Number of Securities	Unrealized Losses	Fair Value	Number of Securities	Unrealized Losses	Fair Value
U.S. government agency mortgage-backed	4	\$ 19	\$ 27,935	-	\$ -	\$ -	4	\$ 19	\$ 27,935
Corporate bonds	11	982	28,605	-	-	-	11	982	28,605
Collateralized mortgage obligations	3	736	9,032	-	-	-	3	736	9,032
Asset-backed securities	4	414	28,341	-	-	-	4	414	28,341
Collateralized debt obligations	-	-	-	2	7,918	9,974	2	7,918	9,974
	22	\$ 2,151	\$ 93,913	2	\$ 7,918	\$ 9,974	24	\$ 10,069	\$ 103,887

Recognition of other-than-temporary impairment for these securities was not necessary in the nine months ended September 30, 2012, or the year ended December 31, 2011. The changes in fair values related primarily to interest rate fluctuations and were generally not related to credit quality deterioration. Further as shown below, the amount of deferrals and defaults in the pooled collateralized debt obligations ( CDO ) decreased in the period from December 31, 2011, to September 30, 2012.

Uncertainty in the financial markets in the periods presented has resulted in reduced liquidity for certain investments, particularly the CDO. In the case of the CDO fair value measurement, management included a risk premium adjustment as of September 30, 2012, to reflect an estimated yield that a market participant would demand because of uncertainty in cash flows, based on incomplete and sporadic levels of market activity. Accordingly, management continues to designate these securities as Level 3 securities as described in Note 12 of this quarterly report as of September 30, 2012. Management does not have the intent to sell the above securities and it is more likely than not the Company will not sell the securities before recovery of its cost basis.

Below is additional information as it relates to the CDO, Trapeza 2007-13A, which is secured by a pool of trust preferred securities issued by trusts sponsored by multiple financial institutions.

	Amortized	Fair	Gross	S&P	Number of	Issuance		Issuance	
	Cost	Value	Unrealized Loss	Credit Rating 1	Banks in Issuance	Deferrals & Defaults Amount	Collateral %	Excess Subordination Amount	Collateral %
<b>September 30, 2012</b>									
Class A1	\$ 9,039	\$ 5,403	\$ (3,636)	BB+	63	\$ 208,000	27.7%	\$ 190,670	25.4%
Class A2A	8,863	4,140	(4,723)	B+	63	208,000	27.7%	93,670	12.5%
	\$ 17,902	\$ 9,543	\$ (8,359)						

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Class A1	\$	9,136	\$	5,584	\$	(3,552)	CCC+	63	\$	212,750	28.4%	\$	181,630	24.2%
Class A2A		8,756		4,390		(4,366)	CCC-	63		212,750	28.4%		84,630	11.3%
	\$	17,892	\$	9,974	\$	(7,918)								

1 Moody's credit rating for class A1 and A2A were Baa2 and Ba2, respectively, as of September 30, 2012, and unchanged from December 31, 2011. The Fitch ratings for class A1 and A2A were BBB and B, respectively, as of September 30, 2012, and unchanged from December 31, 2011.

Table of Contents**Note 3 Loans**

Major classifications of loans were as follows:

	September 30, 2012	December 31, 2011
Commercial	\$ 81,438	\$ 98,099
Real estate - commercial	621,715	704,492
Real estate - construction	48,606	71,436
Real estate - residential	436,837	477,200
Consumer	3,167	3,789
Overdraft	613	457
Lease financing receivables	3,229	2,087
Other	12,677	11,498
	1,208,282	1,369,058
Net deferred loan fees and costs	7	(73)
	\$ 1,208,289	\$ 1,368,985

It is the policy of the Company to review each prospective credit in order to determine whether an adequate level of security or collateral was obtained prior to making a loan. The type of collateral, when required, varies from liquid assets to real estate. The Company's access to collateral, in the event of borrower default, is assured through adherence to state lending laws, the Company's lending standards and credit monitoring procedures. The Bank generally makes loans solely within its market area. There are no significant concentrations of loans where the customers' ability to honor loan terms is dependent upon a single economic sector, although the real estate related categories listed above represent 91.6% and 91.5% of the portfolio at September 30, 2012, and December 31, 2011, respectively. The Company remains committed to overseeing and managing its loan portfolio to reduce its real estate credit concentrations in accordance with the requirements of the Stipulation and Consent to the Issuance of a Consent Order (the "Consent Order") with the Bank and the Office of the Comptroller of the Currency (OCC). Regulatory and capital matters, including the Consent Order, are discussed in more detail in Note 11 of the consolidated financial statements included in this report.

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

<b>September 30, 2012</b>	30-59 Days Past Due	60-89 Days Past Due	90 Days or Greater Past Due	Total Past Due	Current	Nonaccrual	Total Financing Receivables	Recorded Investment 90 days or Greater Past Due and Accruing
Commercial	\$ 200	\$ 68	\$ -	\$ 268	\$ 83,242	\$ 1,157	\$ 84,667	\$ -
Real estate - commercial								
Owner occupied general purpose	578	591	-	1,169	123,503	5,901	130,573	-
Owner occupied special purpose	24	71	-	95	154,129	12,889	167,113	-
Non-owner occupied general purpose	503	-	1,256	1,759	125,261	19,664	146,684	1,256
Non-owner occupied special purpose	-	-	-	-	97,995	487	98,482	-
Retail properties	-	-	-	-	38,552	11,721	50,273	-
Farm	-	-	-	-	26,800	1,790	28,590	-
Real estate - construction								
Homebuilder	265	-	47	312	4,764	5,523	10,599	47
Land	307	-	-	307	7,232	17	7,556	-
Commercial speculative	-	-	-	-	7,597	7,486	15,083	-
All other	-	-	-	-	14,732	636	15,368	-
Real estate - residential								
Investor	975	-	169	1,144	147,137	12,838	161,119	169
Owner occupied	-	449	100	549	119,782	9,368	129,699	100
Revolving and junior liens	973	417	-	1,390	141,384	3,245	146,019	-
Consumer	25	-	-	25	3,142	-	3,167	-
All other	-	-	-	-	13,297	-	13,297	-
	\$ 3,850	\$ 1,596	\$ 1,572	\$ 7,018	\$ 1,108,549	\$ 92,722	\$ 1,208,289	\$ 1,572

## December 31, 2011

	30-59 Days Past Due	60-89 Days Past Due	90 Days or Greater Past Due	Total Past Due	Current	Nonaccrual	Total Financing Receivables	Recorded Investment 90 days or Greater Past Due and Accruing
Commercial	\$ 161	\$ 20	\$ -	\$ 181	\$ 98,840	\$ 1,165	\$ 100,186	\$ -
Real estate - commercial								
Owner occupied general purpose	912	-	-	912	137,250	12,744	150,906	-
Owner occupied special purpose	-	39	-	39	172,624	16,564	189,227	-
Non-owner occupied general purpose	471	-	318	789	147,099	12,893	160,781	318
Non-owner occupied special purpose	-	-	-	-	107,425	1,814	109,239	-
Retail properties	-	-	-	-	42,535	15,897	58,432	-
Farm	197	-	-	197	34,136	1,574	35,907	-
Real estate - construction								
Homebuilder	-	-	-	-	8,725	10,193	18,918	-
Land	-	-	-	-	7,976	2,025	10,001	-
Commercial speculative	-	669	-	669	5,154	14,217	20,040	-
All other	-	74	-	74	17,714	4,689	22,477	-
Real estate - residential								
Investor	338	3,562	-	3,900	162,101	15,111	181,112	-
Owner occupied	3,414	573	-	3,987	119,266	15,059	138,312	-
Revolving and junior liens	1,525	166	-	1,691	153,244	2,841	157,776	-
Consumer	8	-	-	8	3,781	-	3,789	-

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All other	-	-	-	-	11,882	-	11,882	-
	\$ 7,026	\$ 5,103	\$ 318	\$ 12,447	\$ 1,229,752	\$ 126,786	\$ 1,368,985	\$ 318

Nonaccrual loans and loans past due 90 days still on accrual include both smaller balance homogeneous loans that are collectively evaluated for impairment and individually classified impaired loans.

The Bank had no commitments to any borrower whose loans were classified as impaired at September 30, 2012.

### Credit Quality Indicators:

The Company categorizes loans into credit risk categories based on current financial information, overall debt service coverage, comparison against industry averages, historical payment experience, and current economic trends. Each loan and loan relationship is examined. This analysis includes loans with outstanding loans 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:

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

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

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

Credits that are not covered by the definitions above are pass credits, which are not considered to be adversely rated. Loans listed as not rated have outstanding loans or commitments less than \$50,000 or are included in groups of homogeneous loans.

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Credit Quality Indicators by class of loans were as follows:

### September 30, 2012

	Pass	Special Mention	Substandard 1	Doubtful	Total
Commercial	\$ 82,532	\$ 387	\$ 1,748	\$ -	\$ 84,667
Real estate - commercial					
Owner occupied general purpose	114,064	3,846	12,663	-	130,573
Owner occupied special purpose	138,604	9,697	18,812	-	167,113
Non-owner occupied general purpose	100,478	19,822	26,384	-	146,684
Non-owner occupied special purpose	92,206	4,772	1,504	-	98,482
Retail Properties	32,385	3,531	14,357	-	50,273
Farm	23,666	3,134	1,790	-	28,590
Real estate - construction					
Homebuilder	1,683	2,431	6,485	-	10,599
Land	5,189	-	2,367	-	7,556
Commercial speculative	3,954	-	11,129	-	15,083
All other	13,228	1,504	636	-	15,368
Real estate - residential					
Investor	124,604	20,109	16,406	-	161,119
Owner occupied	116,082	401	13,216	-	129,699
Revolving and junior leins	140,821	145	5,053	-	146,019
Consumer	3,162	-	5	-	3,167
All other	13,077	220	-	-	13,297
Total	\$ 1,005,735	\$ 69,999	\$ 132,555	\$ -	\$ 1,208,289

### December 31, 2011

	Pass	Special Mention	Substandard 1	Doubtful	Total
Commercial	\$ 94,456	\$ 3,350	\$ 2,380	\$ -	\$ 100,186
Real estate - commercial					
Owner occupied general purpose	115,175	11,695	24,036	-	150,906
Owner occupied special purpose	154,650	5,254	29,323	-	189,227
Non-owner occupied general purpose	102,178	19,292	39,311	-	160,781
Non-owner occupied special purpose	85,931	6,017	17,291	-	109,239
Retail Properties	26,391	11,660	20,381	-	58,432
Farm	26,629	5,605	3,673	-	35,907
Real estate - construction					
Homebuilder	4,206	2,905	11,807	-	18,918
Land	3,755	3,032	3,214	-	10,001
Commercial speculative	1,306	-	18,734	-	20,040
All other	17,448	303	4,726	-	22,477
Real estate - residential					
Investor	119,494	28,478	33,140	-	181,112
Owner occupied	118,658	271	19,383	-	138,312
Revolving and junior leins	151,928	821	5,027	-	157,776
Consumer	3,776	-	13	-	3,789
All other	10,755	1,127	-	-	11,882
Total	\$ 1,036,736	\$ 99,810	\$ 232,439	\$ -	\$ 1,368,985

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





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Impaired loans by class of loan as of September 30, 2012 were as follows:

	As of September 30, 2012			Nine Months Ended September 30, 2012	
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
<b>With no related allowance recorded</b>					
Commercial	\$ 519	\$ 562	\$ -	\$ 516	\$ -
Commercial real estate					
Owner occupied general purpose	3,540	3,911	-	4,149	-
Owner occupied special purpose	7,837	9,013	-	10,222	-
Non-owner occupied general purpose	13,691	17,868	-	10,996	210
Non-owner occupied special purpose	487	637	-	933	-
Retail properties	7,115	10,092	-	5,851	-
Farm	1,593	1,595	-	1,335	-
Construction					
Homebuilder	5,231	6,439	-	7,952	83
Land	17	17	-	1,021	-
Commercial speculative	3,045	5,758	-	6,297	-
All other	99	239	-	2,204	-
Residential					
Investor	6,020	13,670	-	4,500	-
Owner occupied	9,696	11,111	-	10,788	187
Revolving and junior liens	1,442	1,664	-	1,466	2
Consumer	-	-	-	-	-
Total impaired loans with no recorded allowance	60,332	82,576	-	68,230	482
<b>With an allowance recorded</b>					
Commercial	638	686	514	646	-
Commercial real estate					
Owner occupied general purpose	2,361	2,475	337	5,173	-
Owner occupied special purpose	5,052	6,948	896	4,505	-
Non-owner occupied general purpose	9,697	13,231	350	9,047	-
Non-owner occupied special purpose	-	-	-	217	-
Retail properties	4,606	7,838	1,413	7,958	-
Farm	197	197	117	347	-
Construction					
Homebuilder	2,618	7,451	121	2,411	-
Land	-	-	-	-	-
Commercial speculative	4,441	5,047	895	4,554	-
All other	537	652	392	459	-
Residential					
Investor	6,818	8,093	875	9,552	-
Owner occupied	5,079	6,332	811	6,726	34
Revolving and junior liens	1,864	2,076	864	1,608	-
Consumer	-	-	-	-	-
Total impaired loans with a recorded allowance	43,908	61,026	7,585	53,203	34
Total impaired loans	\$ 104,240	\$ 143,602	\$ 7,585	\$ 121,433	\$ 516

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Impaired loans by class of loans as of December 31, 2011 were as follows:

	As of December 31, 2011			Nine Months Ended September 30, 2011	
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
<b>With no related allowance recorded</b>					
Commercial	\$ 512	\$ 560	\$ -	\$ 220	\$ -
Commercial real estate					
Owner occupied general purpose	4,759	6,538	-	4,725	-
Owner occupied special purpose	12,606	15,862	-	11,122	-
Non-owner occupied general purpose	8,301	11,734	-	10,324	166
Non-owner occupied special purpose	1,380	1,545	-	3,537	22
Retail properties	4,586	5,920	-	7,193	-
Farm	1,078	1,198	-	908	-
Construction					
Homebuilder	10,672	17,643	-	15,263	104
Land	2,025	6,222	-	5,779	-
Commercial speculative	9,549	27,134	-	5,259	-
All other	4,309	6,576	-	5,183	-
Residential					
Investor	2,981	11,927	-	7,550	-
Owner occupied	11,880	13,487	-	14,655	210
Revolving and junior liens	1,489	1,693	-	1,433	-
Consumer	-	-	-	4	-
Total impaired loans with no recorded allowance	76,127	128,039	-	93,155	502
<b>With an allowance recorded</b>					
Commercial	653	740	392	2,088	-
Commercial real estate					
Owner occupied general purpose	7,985	8,291	1,397	10,554	-
Owner occupied special purpose	3,958	5,448	407	9,149	-
Non-owner occupied general purpose	8,397	9,942	2,187	9,325	-
Non-owner occupied special purpose	434	437	98	4,262	-
Retail properties	11,311	12,389	3,506	14,885	-
Farm	496	496	28	-	-
Construction					
Homebuilder	2,204	2,816	376	5,865	-
Land	-	-	-	6,096	-
Commercial speculative	4,668	5,371	1,683	10,193	-
All other	380	422	225	339	-
Residential					
Investor	12,287	12,844	1,808	7,885	28
Owner occupied	8,373	9,762	626	7,367	90
Revolving and junior liens	1,352	1,656	321	622	-
Consumer	-	-	-	-	-
Total impaired loans with a recorded allowance	62,498	70,614	13,054	88,630	118
Total impaired loans	\$ 138,625	\$ 198,653	\$ 13,054	\$ 181,785	\$ 620

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 does participate in the U.S. Department of the Treasury's (the Treasury) Home Affordable Modification Program ( HAMP ) which gives qualifying homeowners an opportunity to refinance into more affordable monthly payments.

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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

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resulting amount is less than the recorded book value, the Bank either establishes a valuation allowance (i.e. specific reserve) as a component of the allowance for loan losses or charges off the impaired balance if it determines that such amount is a confirmed loss. This method is used consistently for all segments of the portfolio. The allowance for loan losses also includes an allowance based on a loss migration analysis for each loan category for loans that are not individually evaluated for specific impairment. All loans charged-off, including TDR charged-off, are factored into this calculation by portfolio segment.

TDRs outstanding by class are summarized as follows:

	As of September 30, 2012			
	TDR Modifications Accruing interest		TDR Modifications Nonaccrual	
	# of contracts	Recorded investment	# of contracts	Recorded investment
<b>Troubled debt restructurings</b>				
Commercial	-	\$ -	1	\$ 17
Real estate - commercial				
Owner occupied general purpose	-	-	1	434
Owner occupied special purpose	-	-	1	350
Non-owner occupied general purpose	2	3,724	4	4,341
Non-owner occupied special purpose	-	-	2	487
Real estate - construction				
Homebuilder	2	2,326	1	1,250
Commercial speculative	-	-	1	419
Real estate - residential				
Investor	-	-	5	1,269
Owner occupied	34	5,407	16	2,753
Revolving and junior liens	1	61	-	-
	39	\$ 11,518	32	\$ 11,320

	As of December 31, 2011			
	TDR Modifications Accruing interest		TDR Modifications Nonaccrual	
	# of contracts	Recorded investment	# of contracts	Recorded investment
<b>Troubled debt restructurings</b>				
Commercial	-	\$ -	1	\$ 17
Real estate - commercial				
Owner occupied general purpose	-	-	2	147
Owner occupied special purpose	-	-	2	377
Non-owner occupied general purpose	2	3,805	4	2,488
Non-owner occupied special purpose	-	-	1	434
Real estate - construction				
Homebuilder	2	2,683	6	4,474
Land	-	-	1	737
Commercial speculative	-	-	1	65
Real estate - residential				
Investor	1	157	6	1,931
Owner occupied	34	5,194	30	5,519
	39	\$ 11,839	54	\$ 16,189



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

	TDR Modifications Three months ended September 30, 2012			TDR Modifications Nine months ended September 30, 2012		
	# of contracts	Pre-modification recorded investment	Post-modification recorded investment	# of contracts	Pre-modification recorded investment	Post-modification recorded investment
<b>Accruing interest:</b>						
<b>Troubled debt</b>						
<b>restructurings</b>						
Real estate - residential						
Owner occupied						
Deferral1	-	\$ -	\$ -	1	\$ 108	\$ 108
Revolving and junior liens						
HAMP2	-	-	-	1	117	61
	-	\$ -	\$ -	2	\$ 225	\$ 169

	TDR Modifications Three months ended September 30, 2012			TDR Modifications Nine months ended September 30, 2012		
	# of contracts	Pre-modification recorded investment	Post-modification recorded investment	# of contracts	Pre-modification recorded investment	Post-modification recorded investment
<b>Nonaccrual:</b>						
<b>Troubled debt</b>						
<b>restructurings</b>						
Real estate - commercial						
Deferral1	1	\$ 689	\$ 433	2	\$ 898	\$ 640
Interest3	-	-	-	2	3,381	3,148
Real estate - residential						
Investor						
Deferral1	1	405	167	2	405	167
Bifurcate4	-	-	-	1	337	88
	2	\$ 1,094	\$ 600	7	\$ 5,021	\$ 4,043

1. Deferral: Refers to the deferral of principal
2. HAMP: Home Affordable Modification Program
3. Interest: Interest rate concession below normal market
4. Bifurcate: Refers to an A/B restructure separated into two notes, charging off the entire B portion of the note.

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TDRs are classified as being in default on a case-by-case basis when they fail to be in compliance with their modified terms. The following table presents TDR that defaulted during the periods shown and were restructured within the 12 month period prior to default:

	TDR Default Activity		TDR Default Activity	
	Three Months ending September 30, 2012		Nine Months ending September 30, 2012	
	# of	Pre-modification outstanding	# of	Pre-modification outstanding
	contracts	recorded investment	contracts	recorded investment
Troubled debt restructurings that				
Subsequently Defaulted				
Real estate - construction				
Commercial speculative	1	\$ 460	1	\$ 460
	1	\$ 460	1	\$ 460

	TDR Default Activity		TDR Default Activity	
	Three Months ending September 30, 2011		Nine Months ending September 30, 2011	
	# of	Pre-modification outstanding	# of	Pre-modification outstanding
	contracts	recorded investment	contracts	recorded investment
Troubled debt restructurings that				
Subsequently Defaulted				
Real estate - construction				
Commercial speculative	-	\$ -	1	\$ 69
Real estate - residential				
Investor	-	-	1	196
Owner occupied	-	-	11	1,803
	-	\$ -	13	\$ 2,068



Table of Contents**Note 4 Allowance for Loan Losses**

Changes in the allowance for loan losses by segment of loans based on method of impairment for the three and nine months ended September 30, 2012, were as follows:

<b>Allowance for credit losses:</b>	Commercial	Real Estate Commercial 1	Real Estate Construction	Real Estate Residential	Consumer	Unallocated	Total
<b>Three months Ended September 30, 2012</b>							
Balance at beginning of period	\$ 4,783	\$ 23,766	\$ 5,501	\$ 4,141	\$ 1,063	\$ 1,032	\$ 40,286
Charge-offs	2	355	909	1,230	186	-	2,682
Recoveries	22	76	2,202	219	134	-	2,653
Provision	(251)	(939)	(2,366)	1,342	104	2,110	-
Ending balance	\$ 4,552	\$ 22,548	\$ 4,428	\$ 4,472	\$ 1,115	\$ 3,142	\$ 40,257
<b>Nine months Ended September 30, 2012</b>							
Balance at beginning of year	\$ 5,070	\$ 30,770	\$ 7,937	\$ 6,335	\$ 884	\$ 1,001	\$ 51,997
Charge-offs	110	12,694	4,251	6,416	463	-	23,934
Recoveries	32	1,698	3,373	452	355	-	5,910
Provision	(440)	2,774	(2,631)	4,101	339	2,141	6,284
Ending balance	\$ 4,552	\$ 22,548	\$ 4,428	\$ 4,472	\$ 1,115	\$ 3,142	\$ 40,257
Ending balance: Individually evaluated for impairment	\$ 514	\$ 3,113	\$ 1,408	\$ 2,550	\$ -	\$ -	\$ 7,585
Ending balance: Collectively evaluated for impairment	\$ 4,038	\$ 19,435	\$ 3,020	\$ 1,922	\$ 1,115	\$ 3,142	\$ 32,672
<b>Financing receivables:</b>							
Ending balance	\$ 84,667	\$ 621,715	\$ 48,606	\$ 436,837	\$ 3,167	\$ 13,297	\$ 1,208,289
Ending balance: Individually evaluated for impairment	\$ 1,157	\$ 56,176	\$ 15,988	\$ 30,919	\$ -	\$ -	\$ 104,240
Ending balance: Collectively evaluated for impairment	\$ 83,510	\$ 565,539	\$ 32,618	\$ 405,918	\$ 3,167	\$ 13,297	\$ 1,104,049

**1** As of September 30, 2012, this segment consisted of performing loans that included a higher risk pool of loans rated as substandard that totaled \$19.7 million. The amount of general allocation that was estimated for that portion of these performing substandard rated loans was \$2.2 million at September 30, 2012.

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Changes in the allowance for loan losses by segment of loans based on method of impairment for the three and nine months ended September 30, 2011, were as follows:

<b>Allowance for credit losses:</b>	Commercial	Real Estate Commercial 1	Real Estate Construction	Real Estate Residential	Consumer	Unallocated	Total
<b>Three months Ended September 30, 2011</b>							
Balance at beginning of period	\$ 5,666	\$ 36,776	\$ 13,325	\$ 8,217	\$ 819	\$ 1,215	\$ 66,018
Charge-offs	143	4,675	2,029	3,882	169	-	10,898
Recoveries	109	771	594	128	130	-	1,732
Provision	(874)	2,221	(352)	1,917	114	(26)	3,000
Ending balance	\$ 4,758	\$ 35,093	\$ 11,538	\$ 6,380	\$ 894	\$ 1,189	\$ 59,852
<b>Nine months Ended September 30, 2011</b>							
Balance at beginning of year	\$ 6,764	\$ 42,242	\$ 18,344	\$ 6,999	\$ 880	\$ 1,079	\$ 76,308
Charge-offs	298	15,752	7,228	7,266	433	-	30,977
Recoveries	153	3,837	1,212	1,467	352	-	7,021
Provision	(1,861)	4,766	(790)	5,180	95	110	7,500
Ending balance	\$ 4,758	\$ 35,093	\$ 11,538	\$ 6,380	\$ 894	\$ 1,189	\$ 59,852
Ending balance: Individually evaluated for impairment	\$ 376	\$ 6,377	\$ 6,037	\$ 2,106	\$ -	\$ -	\$ 14,896
Ending balance: Collectively evaluated for impairment	\$ 4,382	\$ 28,716	\$ 5,501	\$ 4,274	\$ 894	\$ 1,189	\$ 44,956
<b>Financing receivables:</b>							
Ending balance	\$ 109,812	\$ 730,554	\$ 77,958	\$ 489,985	\$ 4,187	\$ 11,461	\$ 1,423,957
Ending balance: Individually evaluated for impairment	\$ 948	\$ 64,574	\$ 39,940	\$ 30,245	\$ -	\$ -	\$ 135,707
Ending balance: Collectively evaluated for impairment	\$ 108,864	\$ 665,980	\$ 38,018	\$ 459,740	\$ 4,187	\$ 11,461	\$ 1,288,250

**1** As of September 30, 2011, this segment consisted of performing loans that included a higher risk pool of loans rated as substandard that totaled \$74.6 million. The amount of general allocation that was estimated for that portion of these performing substandard rated loans was \$14.1 million at September 30, 2011.

Table of Contents**Note 5 Other Real Estate Owned**

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
<u>Other real estate owned</u>				
Balance at beginning of period	\$ 89,671	\$ 82,611	\$ 93,290	\$ 75,613
Property additions	7,594	29,842	26,944	60,355
Development improvements	131	394	646	2,561
Less:				
Property disposals, net of gains/losses	4,829	9,574	20,517	28,754
Period valuation adjustments	4,474	2,719	12,270	9,221
Balance at end of period	\$ 88,093	\$ 100,554	\$ 88,093	\$ 100,554

Activity in the valuation allowance was as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Balance at beginning of period	\$ 27,469	\$ 21,504	\$ 23,462	\$ 22,220
Provision for unrealized losses	4,474	2,719	12,101	9,153
Reductions taken on sales	(2,657)	(2,414)	(6,446)	(9,632)
Other adjustments	-	-	169	68
Balance at end of period	\$ 29,286	\$ 21,809	\$ 29,286	\$ 21,809

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Gain on sales, net	\$ (20)	\$ (297)	\$ (398)	\$ (933)
Provision for unrealized losses	4,474	2,719	12,101	9,153
Operating expenses	2,071	2,634	5,886	7,465
Less:				
Lease revenue	840	1,060	2,930	2,537
	\$ 5,685	\$ 3,996	\$ 14,659	\$ 13,148

Table of Contents**Note 6 Deposits**

Major classifications of deposits were as follows:

	September 30, 2012	December 31, 2011
Noninterest bearing demand	\$ 381,111	\$ 361,963
Savings	211,452	196,870
NOW accounts	265,215	275,957
Money market accounts	321,614	288,508
Certificates of deposit of less than \$100,000	323,464	390,530
Certificates of deposit of \$100,000 or more	194,078	226,953
	\$ 1,696,934	\$ 1,740,781

**Note 7 Borrowings**

The following table is a summary of borrowings as of September 30, 2012, and December 31, 2011. Junior subordinated debentures are discussed in detail in Note 8:

	September 30, 2012	December 31, 2011
Securities sold under repurchase agreements	\$ 1,738	\$ 901
Junior subordinated debentures	58,378	58,378
Subordinated debt	45,000	45,000
Notes payable and other borrowings	500	500
	\$ 105,616	\$ 104,779

The Company enters into sales of securities under agreements to repurchase (repurchase agreements) which generally mature within 1 to 90 days from the transaction date. These repurchase agreements are treated as financings and were secured by mortgage-backed securities with a carrying amount of \$20.9 and \$3.7 million at September 30, 2012, and December 31, 2011, respectively. The securities sold under agreements to repurchase consisted of U.S. government agencies and mortgage-backed securities during the subject reporting periods.

The Company's borrowings at the FHLBC require the Bank to be a member and invest in the stock of the FHLBC and are generally limited to the lesser of 35% of total assets or 60% of the book value of certain mortgage loans. The Bank owned FHLBC stock of \$7.0 million at September 30, 2012, and had total funding availability of \$65.5 million with no outstanding advances. At December 31, 2011, there were no outstanding advances on the FHLBC stock of \$9.3 million and funding availability was \$48.4 million. The Company has also established borrowing capacity at the FRB that was not used at either September 30, 2012, or December 31, 2011. The Company currently has \$64.3 million of borrowing capacity at the FRB at the current secondary rate of 1.25%.

One of the Company's most significant borrowing relationships continues to be the \$45.5 million credit facility with Bank of America. That credit facility, which began in January 2008, was originally comprised of a \$30.5 million senior debt facility, which included a \$30.0 million

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revolving line that matured on March 31, 2010, and \$500,000 in term debt (together, the Senior Debt ), as well as \$45.0 million of subordinated debt (the Subordinated Debt ). The Subordinated Debt and the term debt portions of the Senior Debt mature on March 31, 2018. The interest rate on the Senior Debt resets quarterly and at the Company's option, based on 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 Bank of America senior line of credit when it matured, but did have \$500,000 in principal outstanding in term debt and \$45.0 million in principal outstanding in Subordinated Debt at the end of both December 31, 2011, and September 30, 2012. The term

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debt is secured by all of the outstanding capital stock of the Bank. The Company has made all required interest payments on the outstanding principal amounts on a timely basis.

The credit facility agreement contains usual and customary provisions regarding acceleration of the senior debt upon the occurrence of an event of default by the Company under the agreement, as described therein. The agreement also contains certain customary representations and warranties as well as financial covenants. At September 30, 2012, the Company continued to be out of compliance with two of the financial covenants. The agreement provides that upon an event of default as the result of the Company's failure to comply with a financial covenant, the lender may (i) terminate all commitments to extend further credit, (ii) increase the interest rate on the revolving line and the term debt by 200 basis points, (iii) declare the Senior Debt immediately due and payable and (iv) exercise all of its rights and remedies at law, in equity and/or pursuant to any or all collateral documents, including foreclosing on the collateral. The total outstanding principal amount of the Senior Debt is the \$500,000 in term debt. Because the Subordinated Debt is treated as Tier 2 capital for regulatory capital purposes, the agreement does not provide the lender with any rights of acceleration or other remedies with regard to the Subordinated Debt upon an event of default caused by the Company's failure to comply with a financial covenant. In November 2009, the lender provided notice to the Company that it was invoking the default rate. This action by the lender resulted in nominal additional interest expense as it only applies to the \$500,000 of outstanding term debt.

## **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 was sold in July 2003. The costs associated with the issuance of the cumulative trust preferred securities are being amortized over 30 years. 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. The stated call period commenced on June 30, 2008 and can be exercised by the Company from time to time thereafter. When not in deferral, cash distributions on the securities are payable quarterly at an annual rate of 7.80%. The Company issued a new \$32.6 million subordinated debenture to the trust in return for the aggregate net proceeds of this trust preferred offering. The interest rate and payment frequency on the debenture are equivalent to the cash distribution basis on the trust preferred securities.

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

Under the terms of the subordinated debentures issued to each of Old Second Capital Trust I and II, the Company is allowed to defer payments of interest for 20 consecutive quarterly periods without default or penalty, but interest will continue to accrue. Also during the deferral period, the Company generally may not pay cash dividends on or repurchase its common stock or preferred stock, including the Series B Fixed Rate Cumulative Perpetual Preferred Stock (the "Series B Preferred Stock") as discussed in Note 15. In August of 2010, the Company elected to defer regularly scheduled interest payments on the \$58.4 million of junior subordinated debentures. Because of the deferral on the subordinated debentures, the trusts will defer regularly scheduled dividends on the trust preferred securities. Both of the debentures issued by the Company are recorded on the Consolidated Balance Sheets as junior subordinated debentures and the related interest expense for each issuance is included in the Consolidated Statements of Operations. The total accumulated unpaid interest on the junior subordinated debentures including compounded interest from July 1, 2010, on the deferred payments totaled \$10.5 million at September 30, 2012.



Table of Contents**Note 9 Long-Term Incentive Plan**

The Long-Term Incentive Plan (the Incentive Plan ) authorizes the issuance of up to 1,908,332 shares of the Company's common stock, including the granting of qualified stock options, non-qualified stock options, restricted stock, restricted stock units, and stock appreciation rights. Total shares issuable under the plan were 10,925 at September 30, 2012. Stock based awards may be granted to selected directors and officers or employees at the discretion of the board of directors. There were no stock options granted in the first nine months of 2012 or 2011. All outstanding stock options were granted for a term of ten years.

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

Total compensation cost that has been charged against income for those plans was \$67,000 in the third quarter of 2012 and \$220,000 in the first nine months of 2012.

There were no stock options exercised during the third quarter of 2012 or 2011. The Company did not grant any options of the Company's common stock during either of those periods. There was no unrecognized compensation cost related to nonvested stock options granted under the Incentive Plan in the first nine months of 2012. Total unrecognized compensation cost related to nonvested stock options granted under the Incentive Plan was \$2,000 in the first nine months of 2011, and was recognized over a weighted-average period of 0.33 years.

A summary of stock option activity in the Incentive Plan is as follows:

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (years)	Aggregate Intrinsic Value
Beginning outstanding at January 1, 2012	500,000	\$ 27.34		
Canceled	(28,500)	25.54		
Ending outstanding at September 30, 2012	471,500	\$ 27.45	2.87	\$ -
Exercisable at end of period	471,500	\$ 27.45	2.87	\$ -
Beginning outstanding at January 1, 2011	614,832	\$ 25.81		
Canceled	(21,500)	27.73		
Ending outstanding at September 30, 2011	593,332	\$ 25.74	3.32	\$ -
Exercisable at end of period	589,332	\$ 25.87	3.30	\$ -



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Under the Incentive Plan, restricted stock was granted beginning in 2005 and the grant of restricted units began in February 2009. Both of these restricted awards have voting and dividend rights and are subject to forfeiture until certain restrictions have lapsed including employment for a specific period. There were no restricted awards issued during the third quarter of 2012 and 60,000 restricted awards issued for the nine months ending September 30, 2012. There were 15,000 restricted awards issued during the third quarter of 2011 and 156,000 restricted awards issued for the nine months ending September 30, 2011. Compensation expense is recognized over the vesting period of the restricted award based on the market value of the award at issue date.

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A summary of changes in the Company's nonvested shares of restricted share rights is as follows:

	September 30, 2012		September 30, 2011	
	Shares	Weighted Average Grant Date Fair Value	Shares	Weighted Average Grant Date Fair Value
Nonvested at January 1	426,192	\$ 4.15	464,298	\$ 6.76
Granted	60,000	1.25	156,320	1.06
Vested	(144,976)	7.14	(98,770)	10.71
Forfeited	(13,296)	3.28	(95,656)	5.04
Nonvested at September 30	327,920	\$ 2.33	426,192	\$ 4.15

Total unrecognized compensation cost of restricted awards was \$161,000 as of September 30, 2012, which is expected to be recognized over a weighted-average period of 0.93 years. Total unrecognized compensation cost of restricted awards was \$636,000 as of September 30, 2011, which was expected to be recognized over a weighted-average period of 1.02 years.

## **Note 10 Loss Per Share**

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2012	2011	2012	2011
Basic earnings (loss) per share:				
Weighted-average common shares outstanding	14,084,328	14,034,991	14,070,783	14,014,841
Weighted-average common shares less stock based awards	13,883,008	13,789,971	13,873,819	13,783,340
Weighted-average common shares stock based awards	327,920	427,245	332,198	439,052
Net income (loss)	\$ 120	\$ (1,390)	\$ (1,596)	\$ (3,497)
Dividends and accretion of discount on preferred shares	1,255	1,190	3,716	3,524
Net loss available to common shareholders	(1,135)	(2,580)	(5,312)	(7,021)
Undistributed loss	(1,135)	(2,580)	(5,312)	(7,021)
Basic loss per share common undistributed loss	(0.08)	(0.18)	(0.37)	(0.49)
Basic loss per share	\$ (0.08)	\$ (0.18)	\$ (0.37)	\$ (0.49)
Diluted loss per share:				
Weighted-average common shares outstanding	14,084,328	14,034,991	14,070,783	14,014,841
Dilutive effect of restricted shares <sup>1</sup>	126,600	182,225	135,234	207,551
Diluted average common shares outstanding	14,210,928	14,217,216	14,206,017	14,222,392
Net loss available to common stockholders	\$ (1,135)	\$ (2,580)	\$ (5,312)	\$ (7,021)
Diluted loss per share	\$ (0.08)	\$ (0.18)	\$ (0.37)	\$ (0.49)

Number of antidilutive options excluded from the diluted earnings per share calculation 1,286,839 1,408,671 1,286,839 1,408,671

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

**Note 11 Regulatory & Capital Matters**

On May 16, 2011, the Bank, the wholly-owned banking subsidiary of the Company, entered into the Consent Order with the OCC. Pursuant to the Consent Order, the Bank has agreed to take certain actions and operate in compliance with the Consent Order's provisions during its terms.

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Under the terms of the Consent Order, the Bank is required to, among other things: (i) adopt and adhere to a three-year written strategic plan that establishes objectives for the Bank's overall risk profile, earnings performance, growth, balance sheet mix, off-balance sheet activities, liability structure, capital adequacy, reduction in nonperforming assets and product development; (ii) adopt and maintain a capital plan; (iii) by September 30, 2011, achieve and thereafter maintain a total risk-based capital ratio of at least 11.25% and a Tier 1 capital ratio of at least 8.75%; (iv) seek approval of the OCC prior to paying any dividends on its capital stock; (v) develop a program to reduce the Bank's credit risk; (vi) obtain or update appraisals on certain loans secured by real estate; (vii) implement processes to ensure that real estate valuations conform to applicable standards; (viii) take certain actions related to credit and collateral exceptions; (ix) reaffirm the Bank's liquidity risk management program; and (x) appoint a compliance committee of the Bank's Board of Directors to help ensure the Bank's compliance with the Consent Order. The Bank is also required to submit certain reports to the OCC with respect to the foregoing requirements.

Both capital ratio objectives in the OCC agreement have been exceeded since June 30, 2011. At September 30, 2012, the Bank's leverage ratio was 9.66%, an increase of 32 basis points from December 31, 2011, and 91 basis points above the objective of 8.75%. The Bank's total capital ratio was 14.06%, up 109 basis points from December 31, 2011, and 281 basis points above the objective of 11.25%.

On July 22, 2011, the Company entered into a Written Agreement with the FRB (the "Written Agreement"). Pursuant to the Written Agreement, the Company has agreed to take certain actions and operate in compliance with the Written Agreement's provisions during its term.

Under the terms of the Written Agreement, the Company is required to, among other things: (i) serve as a source of strength to the Bank, including ensuring that the Bank complies with the Consent Order; (ii) refrain from declaring or paying any dividend, or taking dividends or other payments representing a reduction in the Bank's capital, each without the prior written consent of the FRB and the Director of the Division of Banking Supervision and Regulation of the Board of Governors of the Federal Reserve System (the "Director"); (iii) refrain, along with its nonbank subsidiaries, from making any distributions on subordinated debentures or trust preferred securities without the prior written consent of the FRB and the Director; (iv) refrain, along with its nonbank subsidiaries, from incurring, increasing or guaranteeing any debt, and from purchasing or redeeming any shares of its capital stock, each without the prior written consent of the FRB; (v) provide the FRB with a written plan to maintain sufficient capital at the Company on a consolidated basis; (vi) provide the FRB with a projection of the Company's planned sources and uses of cash; (vii) comply with certain regulatory notice provisions pertaining to the appointment of any new director or senior executive officer, or the changing of responsibilities of any senior executive officer; and (viii) comply with certain regulatory restrictions on indemnification and severance payments. The Company is also required to submit certain reports to the FRB with respect to the foregoing requirements.

Bank holding companies are required to maintain minimum levels of capital in accordance with Federal Reserve Capital guidelines. The general bank and holding company capital adequacy guidelines are described in the accompanying table, as are the capital ratios of the Company and the Bank, as of September 30, 2012, and December 31, 2011. These ratios are calculated on a consistent basis with the ratios disclosed in the most recent filings with the regulatory agencies.

Earlier this year, the federal bank regulatory agencies issued joint proposed rules that would implement an international capital accord called Basel III, developed by the Basel Committee on Banking Supervision, a committee of central banks and bank supervisors. The proposed rules would apply to all depository organizations in the United States and most of their parent companies and would increase minimum capital ratios, add a new minimum common equity ratio, add a new capital conservation buffer, and would change the risk-weightings of certain assets for the purposes of calculating certain capital ratios. The proposed changes, if implemented, would be phased in from 2013 through 2019. The comment period on the proposed rules expired on October 22, 2012. Various banking associations and industry groups are providing comments on the proposed rules to the regulators and it is unclear when the final rules will be adopted and what changes, if any, may be made to the proposed rules. Management is currently assessing



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the effect of the proposed rules on the Company and the Bank's capital position and will continue to monitor developments with respect to the proposed rules.

At September 30, 2012, the Company, on a consolidated basis, exceeded the minimum thresholds to be considered adequately capitalized under current regulatory defined capital ratios. The Company and the Bank are subject to regulatory capital requirements administered by federal banking agencies. Generally, if adequately capitalized, regulatory approval is not required to accept brokered deposits. However, the Bank is limited in the amount of brokered deposits that it can hold pursuant to the Consent Order.

Capital levels and industry defined regulatory minimum required levels:

	Actual		Minimum Required for Capital Adequacy Purposes		Minimum Required to be Well Capitalized <sup>1</sup>	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
<b>September 30, 2012</b>						
Total capital to risk weighted assets						
Consolidated	\$ 187,106	12.90%	\$ 116,035	8.00%	N/A	N/A
Old Second Bank	203,569	14.06	115,829	8.00	144,786	10.00
Tier 1 capital to risk weighted assets						
Consolidated	93,556	6.45	58,019	4.00	N/A	N/A
Old Second Bank	185,204	12.79	57,922	4.00	86,882	6.00
Tier 1 capital to average assets						
Consolidated	93,556	4.88	76,685	4.00	N/A	N/A
Old Second Bank	185,204	9.66	76,689	4.00	95,861	5.00
<b>December 31, 2011</b>						
Total capital to risk weighted assets						
Consolidated	\$ 191,439	12.38%	\$ 123,709	8.00%	N/A	N/A
Old Second Bank	200,716	12.97	123,803	8.00	154,754	10.00
Tier 1 capital to risk weighted assets						
Consolidated	95,986	6.21	61,827	4.00	N/A	N/A
Old Second Bank	180,981	11.70	61,874	4.00	92,811	6.00
Tier 1 capital to average assets						
Consolidated	95,986	4.98	77,097	4.00	N/A	N/A
Old Second Bank	180,981	9.34	77,508	4.00	96,885	5.00

<sup>1</sup> The Bank exceeded the general minimum regulatory requirements to be considered well capitalized and is in full compliance with heightened capital ratios that it agreed to maintain with the OCC contained within the Consent Order. However, as a result of continuing to be under the Consent Order, the Bank is formally considered adequately capitalized.

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The Company's credit facility with Bank of America includes \$45.0 million in Subordinated Debt. That debt obligation continues to qualify as Tier 2 regulatory capital. In addition, the trust preferred securities continue to qualify as Tier 1 regulatory capital, and the Company treats the maximum amount of this security type allowable under regulatory guidelines as Tier 1 capital. As of September 30, 2012, trust preferred proceeds of \$24.4 million qualified as Tier 1 regulatory capital and \$32.2 million qualified as Tier 2 regulatory capital. As of December 31, 2011, trust preferred proceeds of \$25.9 million qualified as Tier 1 regulatory capital and \$30.7 million qualified as Tier 2 regulatory capital.

### **Dividend Restrictions and Deferrals**

In addition to the above requirements, banking regulations and capital guidelines generally limit the amount of dividends that may be paid by a Bank without prior regulatory approval. Under these regulations,

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the amount of dividends that may be paid in any calendar year is limited to the current year's profits, combined with the retained profit of the previous two years, subject to the capital requirements described above. As a result of operating losses in prior years, funds were no longer available for the payment of dividends by the Bank to the Company and this restriction continued at September 30, 2012.

As discussed in Note 8, as of September 30, 2012, the Company had \$58.4 million of junior subordinated debentures held by two statutory business trusts that it controls. The Company has the right to defer interest payments, which are approximately \$4.9 million each year, on the debentures for a period of up to 20 consecutive quarters, and elected to begin such a deferral period in August 2010. However, all deferred interest must be paid before the Company may pay dividends on its capital stock. Therefore, the Company will not be able to pay dividends on its common stock until all deferred interest on these debentures has been paid in full. The total amount of such deferred and unpaid interest as of September 30, 2012, was \$10.5 million.

Furthermore, as with the debentures discussed above, the Company is prohibited from paying dividends on its common stock unless it has fully paid all accrued dividends on the Series B Preferred Stock. In August 2010, it also began to defer the payment of dividends on such preferred stock. Therefore, in addition to paying all the accrued and unpaid distributions on the debentures set forth above, the Company must also fully pay the Treasury all accrued and unpaid dividends on the Series B Preferred Stock before it may reinstate the payment of dividends on the common stock. The total amount of deferred Series B Preferred Stock dividends as of September 30, 2012, was \$8.1 million. However, agreements with the OCC and the FRB contain restrictions on dividend payments.

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

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

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

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 assumptions about the assumptions that market participants would use in pricing an asset or liability.



The Company uses the following methods and significant assumptions to estimate fair value:

- Securities available-for-sale are valued primarily by a third party pricing agent and both the market and income valuation approaches are implemented using the following types of inputs:
  - o U.S. treasuries are priced using the market approach and utilizing live data feeds from active market exchanges for identical securities.
  - o Government-sponsored agency debt securities are primarily priced using available market information through processes such as benchmark curves, market valuations of like securities, sector groupings and matrix pricing.

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- Other government-sponsored agency securities, mortgage-backed securities and some of the actively traded real estate mortgage investment conduits and collateralized mortgage obligations are primarily priced using available market information including benchmark yields, prepayment speeds, spreads and volatility of similar securities.
- Other inactive government-sponsored agency securities are primarily priced using consensus pricing and dealer quotes.
- State and political subdivisions are largely grouped by characteristics, i.e., 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 and could be valued with Level 3 measurements.
- CDO are collateralized by trust preferred security issuances of other financial institutions. Uncertainty in the financial markets in the periods presented has resulted in reduced liquidity for these investment securities, which continued to affect market pricing in the period presented. To reflect an appropriate fair value measurement, management included a risk premium adjustment to provide an estimate of the yield that a market participant would demand because of uncertainty in cash flows in the discounted cash flow analysis. Management initially made that adjustment to Level 3 valuation at June 30, 2009, because the level of market activity for CDO securities is incomplete and sporadic and information on orderly sale transactions was not generally available.
- Asset-backed securities are priced using a single expected cash flow stream model.
- Marketable equity securities are priced using available market information.
- 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 (interest rate locks) 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 mortgage-backed securities are considered derivatives. Fair values are estimated based on observable changes in mortgage interest rates including mortgage-backed securities prices 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 a valuation pricing model using an income approach based upon readily observable market parameters such as interest rate yield curves.
- Both the credit valuation reserve on current interest rate swap positions and on receivables related to unwound customer interest rate swap positions was determined based upon management's estimate of the amount of credit risk exposure, including available collateral protection and/or by utilizing an estimate related to a probability of default as indicated in the Bank credit policy. Such adjustments would result in a Level 3 classification.
- The fair value of impaired loans with specific allocations of the allowance for loan losses is generally based on recent real estate appraisals. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the appraisers to adjust for differences between the comparable sales and income data available. 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 generally based on third party appraisals of the property, resulting in a Level 3

classification. In cases where the carrying amount exceeds the fair value, less costs to sell, an impairment loss is recognized.

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

The tables below present the balance of assets and liabilities at September 30, 2012, and December 31, 2011, respectively, which are measured by the Company at fair value on a recurring basis:

	September 30, 2012			Total
	Level 1	Level 2	Level 3	
<b>Assets:</b>				
Investment securities available-for-sale				
U.S. Treasury	\$ 1,511	\$ -	\$ -	\$ 1,511
U.S. government agencies	-	49,455	-	49,455
U.S. government agency mortgage-backed	-	73,291	-	73,291
States and political subdivisions	-	12,667	138	12,805
Corporate Bonds	-	34,217	-	34,217
Collateralized mortgage obligations	-	96,438	-	96,438
Asset-backed securities	-	135,086	-	135,086
Collateralized debt obligations	-	-	9,543	9,543
Loans held-for-sale	-	5,032	-	5,032
Mortgage servicing rights	-	-	3,603	3,603
Other assets (Interest rate swap agreements net of swap credit valuation)	-	2,299	(61)	2,238
Other assets (Forward MBS)	-	550	-	550
<b>Total</b>	<b>\$ 1,511</b>	<b>\$ 409,035</b>	<b>\$ 13,223</b>	<b>\$ 423,769</b>
<b>Liabilities:</b>				
Other liabilities (Interest rate swap agreements)	\$ -	\$ 2,299	\$ -	\$ 2,299
<b>Total</b>	<b>\$ -</b>	<b>\$ 2,299</b>	<b>\$ -</b>	<b>\$ 2,299</b>

	December 31, 2011			Total
	Level 1	Level 2	Level 3	
<b>Assets:</b>				
Investment securities available-for-sale				
U.S. Treasury	\$ 1,524	\$ -	\$ -	\$ 1,524
U.S. government agencies	-	43,398	-	43,398
U.S. government agency mortgage-backed	-	154,007	-	154,007
States and political subdivisions	-	13,671	138	13,809
Corporate Bonds	-	31,389	-	31,389
Collateralized mortgage obligations	-	25,122	-	25,122
Asset-backed securities	-	28,341	-	28,341
Collateralized debt obligations	-	-	9,974	9,974
Loans held-for-sale	-	12,806	-	12,806
Mortgage servicing rights	-	-	3,487	3,487
Other assets (Interest rate swap agreements net of swap credit valuation)	-	3,152	(80)	3,072
Other assets (Forward MBS)	-	107	-	107
<b>Total</b>	<b>\$ 1,524</b>	<b>\$ 311,993</b>	<b>\$ 13,519</b>	<b>\$ 327,036</b>
<b>Liabilities:</b>				
Other liabilities (Interest rate swap agreements)	\$ -	\$ 3,152	\$ -	\$ 3,152
Other liabilities (Interest rate lock commitments to borrowers)	-	50	-	50
<b>Total</b>	<b>\$ -</b>	<b>\$ 3,202</b>	<b>\$ -</b>	<b>\$ 3,202</b>

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At March 31, 2012, \$3.3 million and at June 30, 2012, \$51.8 million in asset-backed securities were reported in Level 1 using their purchased price. Subsequently, these securities have been included in Level 2 using a third party pricing service.

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

	Nine months ended September 30, 2012			
	Investment securities available-for- sale			
	Collateralized Debt Obligations	States and Political Subdivisions	Mortgage Servicing Rights	Interest Rate Swap Valuation
Beginning balance January 1, 2012	\$ 9,974	\$ 138	\$ 3,487	\$ (80)
Transfers into Level 3	-	-	-	-
Transfers out of Level 3	-	-	-	-
Total gains or losses				
Included in earnings (or changes in net assets)	125	-	(1,315)	19
Included in other comprehensive income	(441)	-	-	-
Purchases, issuances, sales, and settlements				
Purchases	-	-	-	-
Issuances	-	-	1,431	-
Settlements	(115)	-	-	-
Expirations	-	-	-	-
Ending balance September 30, 2012	\$ 9,543	\$ 138	\$ 3,603	\$ (61)

	Nine months ended September 30, 2011					
	Investment securities available-for- sale					
	Equity Securities	Collateralized Debt Obligations	States and political subdivisions	Mortgage Servicing Rights	Interest Rate Swap Valuation	Risk Participation Agreement
Beginning balance January 1, 2011	\$ 6	\$ 11,073	\$ 3,000	\$ 3,897	\$ (108)	\$ (38)
Transfers into Level 3	-	-	-	-	-	-
Transfers out of Level 3	-	-	(3,000)	-	-	-
Total gains or losses						
Included in earnings (or changes in net assets)	-	110	-	(1,144)	(23)	38
Included in other comprehensive income	1	(779)	-	-	-	-
Purchases, issuances, sales, and settlements						
Purchases	-	-	-	-	-	-
Issuances	-	-	-	852	-	-
Settlements	-	(93)	-	-	-	-
Expirations	-	-	-	-	-	-
Ending balance September 30, 2011	\$ 7	\$ 10,311	\$ -	\$ 3,605	\$ (131)	\$ -

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

The Company may be required, from time to time, to measure certain other assets at fair value on a nonrecurring basis in accordance with GAAP. These assets consist of impaired loans and OREO. For assets measured at fair value on a nonrecurring basis at September 30, 2012, and December 31, 2011, respectively, the following tables provide the level of valuation assumptions used to determine each valuation and the carrying value of the related assets:

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	September 30, 2012			
	Level 1	Level 2	Level 3	Total
Impaired loans <sup>1</sup>	\$ -	\$ -	\$ 35,786	\$ 35,786
Other real estate owned, net <sup>2</sup>	-	-	88,093	88,093
<b>Total</b>	\$ -	\$ -	\$ 123,879	\$ 123,879

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. These loans had a carrying amount of \$35.8 million, with a valuation allowance of \$7.6 million, resulting in a decrease of specific allocations within the allowance for loan losses of \$5.4 million for the nine months ending September 30, 2012.

2 OREO, measured at the lower of carrying or fair value less costs to sell, had a net carrying amount of \$88.1 million, which is made up of the outstanding balance of \$117.4 million, net of a valuation allowance of

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\$29.3 million, at September 30, 2012, resulting in a charge to expense of \$12.1 million for the nine months ended September 30, 2012.

	December 31, 2011			
	Level 1	Level 2	Level 3	Total
Impaired loans <sup>1</sup>	\$ -	\$ -	\$ 51,075	\$ 51,075
Other real estate owned, net <sup>2</sup>	-	-	93,290	93,290
Total	\$ -	\$ -	\$ 144,365	\$ 144,365

<sup>1</sup> Represents carrying value and related write-downs of loans for which adjustments are substantially based on the appraised value of collateral for collateral-dependent loans. These loans had a carrying amount of \$64.1 million, with a valuation allowance of \$13.0 million, resulting in a decrease of specific allocations within the allowance for loan losses of \$9.9 million for the year ending December 31, 2011.

<sup>2</sup> OREO is measured at the lower of carrying or fair value less costs to sell and had a net carrying amount of \$93.3 million, which is made up of the outstanding balance of \$116.8 million, net of a valuation allowance of \$23.5 million, at December 31, 2011, resulting in a charge to expense of \$15.1 million for the year ended December 31, 2011.

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

To meet the financing needs of its customers, the Bank, as a subsidiary of the Company, is a party to various financial instruments with off-balance-sheet risk in the normal course of business. These off-balance-sheet financial instruments include commitments to originate and sell loans as well as financial standby, performance standby and commercial letters of credit. The instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the consolidated balance sheet. The Bank's exposure to credit loss in the event of nonperformance by the other party to the financial instruments for loan commitments and letters of credit are represented by the dollar amount of those instruments. Management generally uses the same credit policies and collateral requirements in making commitments and conditional obligations as it does for on-balance-sheet instruments.

#### **Interest Rate Swaps**

The Company also has interest rate derivative positions to assist with risk management that are not designated as hedging instruments. These derivative positions relate to transactions in which the Bank enters into an interest rate swap with a client while at the same time entering into an offsetting interest rate swap with another financial institution. Due to financial covenant violations relating to nonperforming loans, the Bank had \$5.1 million in investment securities pledged to support interest rate swap activity with two correspondent financial institutions at September 30, 2012. The Bank had \$5.2 million in investment securities pledged to support interest rate swap activity with a correspondent financial institution at December 31, 2011. In connection with each transaction, the Bank agrees 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 agrees 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 effectively convert a variable rate loan to a fixed rate loan and is also 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 impact 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



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exposure are discussed in Note 12 above. At September 30, 2012, the notional amount of non-hedging interest rate swaps was \$114.7 million with a weighted average maturity of 1.48 years. At December 31, 2011, the notional amount of non-hedging interest rate swaps was \$117.8 million with a

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weighted average maturity of 2.24 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 by entering into contracts for future deliveries of loans as well as selling forward mortgage-backed securities contracts. Loan interest rate lock commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. Commitments to originate residential mortgage loans held-for-sale and forward commitments to sell residential mortgage loans or forward mortgage backed securities contracts are considered derivative instruments and changes in the fair value are recorded to mortgage banking income. Fair values are estimated based on observable changes in mortgage interest rates including mortgage-backed securities prices from the date of the commitment.

The following table presents derivatives not designated as hedging instruments as of September 30, 2012:

	Notional or Contractual Amount	Asset Derivatives		Liability Derivatives	
		Balance Sheet Location	Fair Value	Balance Sheet Location	Fair Value
Interest rate swap contracts net of credit valuation	\$ 114,693	Other Assets	\$ 2,238	Other Liabilities	\$ 2,299
Commitments <sup>1</sup>	255,438	Other Assets	550	N/A	-
Forward contracts <sup>2</sup>	44,500	N/A	-	Other Liabilities	-
Total			\$ 2,788		\$ 2,299

<sup>1</sup> Includes unused loan commitments, interest rate lock commitments, forward rate lock, and mortgage-backed securities commitments.

<sup>2</sup> Includes forward mortgage backed securities contracts and forward loan contracts.

The following table presents derivatives not designated as hedging instruments as of December 31, 2011:

	Notional or Contractual Amount	Asset Derivatives		Liability Derivatives	
		Balance Sheet Location	Fair Value	Balance Sheet Location	Fair Value
Interest rate swap contracts net of credit valuation	\$ 117,756	Other Assets	\$ 3,072	Other Liabilities	\$ 3,152
Commitments <sup>1</sup>	237,970	Other Assets	107	N/A	-
Forward contracts <sup>2</sup>	26,000	N/A	-	Other Liabilities	50
Total			\$ 3,179		\$ 3,202

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1 Includes unused loan commitments, interest rate lock commitments and forward rate lock and mortgage-backed securities commitments.

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2 Includes forward mortgage backed securities contracts and forward loan contracts.

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

In addition to customer related commitments, the Company is responsible for letters of credit commitments that relate to properties held in OREO. The following table represents the Company's contractual commitments due to letters of credit as of September 30, 2012, and December 31, 2011.

	September 30, 2012	December 31, 2011
Commitments to extend credit: borrowers		
Financial standby letters of credit	\$ 3,400	\$ 2,837
Performance standby letters of credit	6,522	8,554
Commercial letters of credit	51	375
Total letters of credit: borrowers	9,973	11,766
Commitments to extend credit: other		
Financial standby letters of credit	550	550
Performance standby letters of credit	1,229	2,324
Commercial letters of credit	-	-
Total letters of credit: other	1,779	2,874
Total letters of credit		
Financial standby letters of credit	3,950	3,387
Performance standby letters of credit	7,751	10,878
Commercial letters of credit	51	375
Total letters of credit	\$ 11,752	\$ 14,640

**Note 14 Fair Values of Financial Instruments**

The estimated fair values approximate carrying amount for all items except those described in the following table. Investment security fair values are based upon market prices or dealer quotes, and if no such information is available, on the rate and term of the security. The fair value of the CDO included in investment securities includes a risk premium adjustment to provide an estimate of the amount that a market participant would demand because of uncertainty in cash flows and the methods for determining fair value of securities as discussed in detail in Note 12. The carrying value of FHLB stock approximates fair value as the stock is nonmarketable, and can only be sold to the FHLB or another member institution at par. During the first nine months of 2012, we participated in multiple redemptions with the FHLB and using the redemption values as the carrying value, FHLB stock has been transferred to 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 items is not considered material.



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

Carrying Amount	Fair Value	September 30, 2012		
		Level 1	Level 2	Level 3

Carrying Amount	Fair Value	December 31, 2011		
		Level 1	Level 2	Level 3

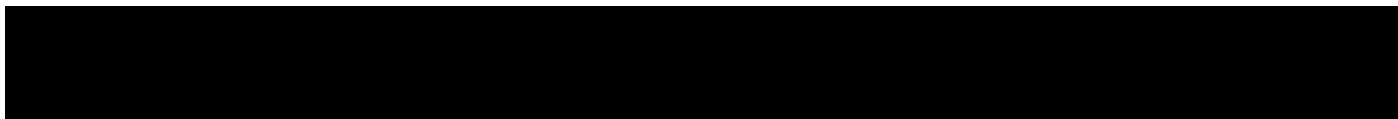


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**Note 15 Preferred Stock**

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

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

As discussed in Note 11, in August 2010 the Company suspended quarterly cash dividends on its outstanding Series B Preferred Stock. Further, as discussed in Note 11, the Company has elected to defer interest payments on certain of its subordinated debentures. During the period in which preferred stock dividends are deferred, such dividends continue to accrue. The terms of the Series B Preferred Stock also prevent the Company from paying cash dividends or generally repurchasing its common stock while Series B Preferred Stock dividends are in arrears. The total amount of such unpaid and deferred Series B Preferred Stock dividends as of September 30, 2012, was \$8.1 million.

Pursuant to the terms of the TARP Capital Purchase Program, the ability of the Company to declare or pay dividends or distributions on, or purchase, redeem or otherwise acquire for consideration, shares of its common stock is subject to restrictions, including a restriction against increasing dividends from the immediately preceding quarter prior to issuance. The redemption, purchase or other acquisition of trust preferred securities of the Company or its affiliates is also restricted. These restrictions will terminate on the earlier of (a) the third anniversary of the date of issuance of the Preferred Stock, (b) the date on which the Series B Preferred Stock has been redeemed in whole or (c) the Treasury has transferred all of the Series B Preferred Stock to third parties.

The TARP Capital Purchase Program also subjects the Company to certain of the executive compensation limitations included in the Emergency Economic Stabilization Act of 2008 (EESA). In connection with the issuance of the Series B Preferred Stock and warrants, the Company's Senior Executive Officers (as defined in the Securities Purchase Agreement, dated January 16, 2009, by and between Old Second Bancorp, Inc. and the Treasury) (i) voluntarily waived any claim against Treasury or the Company for any changes to such officer's compensation or benefits that are required to comply with the TARP Capital Purchase Program as well as EESA and acknowledged that the regulations may require modification of the compensation, bonus, incentive and other benefit plans, arrangements and policies and agreements during the period Treasury owns the Series B Preferred Stock; and (ii) entered into a letter with the Company amending the benefit plans with respect to such Senior Executive Officers, during the period that Treasury owns the Preferred Stock of the Company, as necessary to comply with Section 111(b) of EESA.



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

**Overview**

The Company is a financial services company with its main headquarters located in Aurora, Illinois. The Company is the holding company of the Bank, a national banking organization headquartered in Aurora, Illinois and provides commercial and retail banking services, as well as a full complement of trust and wealth management services. The Company has offices located in Cook, Kane, Kendall, DeKalb, DuPage, LaSalle and Will counties in Illinois. The following management's discussion and analysis is presented to provide information concerning our financial condition as of September 30, 2012, as compared to December 31, 2011, and the results of operations for the three-month and nine-month periods ended September 30, 2012 and 2011. This discussion and analysis should be read in conjunction with our consolidated financial statements and the financial and statistical data appearing elsewhere in this report and our 2011 Form 10-K.

The ongoing weakness in the financial sector and economy, particularly as it relates to credit costs associated with real estate in the Company's market areas, continues to directly affect borrowers' ability to repay their loans. This has resulted in a continued elevated, but improving, level of nonperforming loans. Overall economic weakness is reflected in the Company's operating results, and management remains vigilant in analyzing the loan portfolio quality, making an appropriate loan loss provision and making decisions to charge-off loans. The Company recorded a \$6.3 million provision for loan losses and a net loss of \$1.6 million prior to preferred stock dividends and accretion in the first nine months of 2012. This compared to a \$7.5 million provision for loan losses and a net loss of \$3.5 million prior to preferred stock dividends and accretion for the same period in 2011.

**Results of Operations**

The net income for the third quarter of 2012 was \$120,000, or \$0.08 loss per diluted share, as compared with a \$1.4 million net loss, or \$0.18 loss per diluted share, in the third quarter of 2011. The net loss for the first nine months of 2012 was \$1.6 million or \$0.37 loss per diluted share, as compared to \$3.5 million in net loss, or \$0.49 of loss per diluted share in the first nine months of 2011. The Company recorded a \$6.3 million provision for loan losses in the first nine months of 2012, while the Company did not include any additional provision in the third quarter of 2012. Net loan charge-offs totaled \$18.0 million in the first nine months of 2012, which included \$29,000 of net charge-offs in the third quarter. The provision for loan losses in the first nine months of 2011 was \$7.5 million, which included an addition of \$3.0 million in the third quarter of 2011. Net loan charge-offs totaled \$24.0 million in the first nine months of 2011, which included \$9.2 million of net charge-offs in the third quarter of 2011. The net loss available to common stockholders was \$1.1 million for the third quarter of 2012 and a loss of \$5.3 million for the first nine months of 2012, as compared to net loss available to common shareholders of \$2.6 million and \$7.0 million, respectively, for the same periods in 2011.

***Net Interest Income***

Net interest and dividend income decreased \$3.5 million, from \$48.9 million in the first nine months of 2011, to \$45.4 million in the first nine months of 2012. Average earning assets decreased \$112.3 million, or 6.1%, to \$1.73 billion from the first nine months of 2011 to the first nine

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months of 2012, as management continued to emphasize asset quality and funded new loan originations continued to be limited. The \$281.5 million decrease in year to date average loans and loans held-for-sale was primarily due to the ongoing lower funded demand from qualified borrowers in the Bank's market area, charge-off activity, and movement of loan assets to OREO as well as maturities and payments on performing loans. To utilize available liquid funds, management continued to increase securities available-for-sale in the first nine months of 2012 to

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21.7% of total assets up from 15.8% at the end of 2011 and 9.7% at September 30, 2011. At the same time, management reduced deposits that had previously provided funding for those assets by emphasizing relationship banking rather than single service customers. As a result, average interest bearing liabilities decreased \$110.6 million, or 7.0%, from the first nine months of 2011 to the first nine months of 2012. The net interest margin (tax-equivalent basis), expressed as a percentage of average earning assets, decreased slightly from 3.57% in the first nine months of 2011 to 3.52% in the first nine months of 2012. The average tax-equivalent yield on earning assets decreased from 4.70% in the first nine months of 2011 to 4.39%, or 31 basis points in the first nine months of 2012. The 2012 first nine months of earning asset tax equivalent yield received benefit from collection of previously reversed or unrecognized interest on loans that returned to performing status during the period. The first nine months of 2012 earning asset tax equivalent yield would have been 4.27% without this benefit whereas the first nine months of 2011 would have been 4.63%. During the same period, the cost of funds on interest bearing liabilities decreased from 1.39% to 1.09%, or 30 basis points, helping to offset the decrease in yield. The decrease in average earning assets and movement to lower yielding securities with reduction in higher yielding loan volumes in 2012 were the main causes of decreased interest income.

Net interest and dividend income decreased \$1.3 million from \$15.9 million in the third quarter of 2011 to \$14.6 million in the third quarter of 2012. The decrease in average earning assets on a quarterly comparative basis was \$48.7 million, or 2.8%, from September 30, 2011 to September 30, 2012 due in part to continued low demand from qualified borrowers as well as OREO migration activity in the quarter. Average interest bearing liabilities decreased \$66.2 million, or 4.4%, during the same period. The net interest margin (tax-equivalent basis), expressed as a percentage of average earning assets, decreased from 3.63% in the third quarter of 2011 to 3.44% in the third quarter of 2012. The average tax-equivalent yield on earning assets decreased from 4.73% in the third quarter of 2011 to 4.24% in the third quarter of 2012, or 49 basis points. The 2012 third quarter earning asset tax equivalent yield received benefit from collection of previously reversed or unrecognized interest on loans that returned to performing status during the period. The third quarter 2012 earning asset tax equivalent yield would have been 4.10% without this benefit whereas the third quarter of 2011 would have been 4.65%. The cost of interest-bearing liabilities also decreased from 1.35% to 1.02%, or 33 basis points, in the same period. Consistent with the year to date margin trend, the decreased overall average earning assets and the movement to lower yielding securities combined with the repricing of interest bearing assets and liabilities in a lower interest rate environment decreased interest income to a greater degree than it decreased interest expense.

Management, in order to evaluate and measure performance, uses certain non-GAAP performance measures and ratios. This includes tax-equivalent net interest income (including its individual components) and net interest margin (including its individual components) to total average interest-earning assets. Management believes that these measures and ratios provide users of the financial information with a more accurate view of the performance of the interest-earning assets and interest-bearing liabilities and of the Company's operating efficiency for comparison purposes. Other financial holding companies may define or calculate these measures and ratios differently. See the tables and notes below for supplemental data and the corresponding reconciliations to GAAP financial measures for the three and nine-month periods ended September 30, 2012 and 2011.

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

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ANALYSIS OF AVERAGE BALANCES,  
TAX EQUIVALENT INTEREST AND RATES

Three Months ended September, 2012 and 2011

(Dollar amounts in thousands - unaudited)

	2012			2011		
	Average Balance	Interest	Rate	Average Balance	Interest	Rate
<b>Assets</b>						
Interest bearing deposits	\$ 46,138	\$ 29	0.25%	\$ 91,178	\$ 58	0.25%
Securities:						
Taxable	404,855	1,868	1.85	144,581	928	2.57
Non-taxable (tax equivalent)	9,518	151	6.35	12,172	176	5.78
Total securities	414,373	2,019	1.95	156,753	1,104	2.82
Dividends from FRB and FHLB stock	11,984	77	2.57	14,050	73	2.08
Loans and loans held-for-sale 1	1,230,180	16,279	5.18	1,489,366	19,899	5.23
Total interest earning assets	1,702,675	18,404	4.24	1,751,347	21,134	4.73
Cash and due from banks	31,850	-	-	32,264	-	-
Allowance for loan losses	(40,823)	-	-	(65,660)	-	-
Other noninterest bearing assets	228,859	-	-	241,963	-	-
Total assets	\$ 1,922,561			\$ 1,959,914		
<b>Liabilities and Stockholders' Equity</b>						
NOW accounts	\$ 270,908	\$ 65	0.10%	\$ 259,505	\$ 95	0.15%
Money market accounts	321,762	137	0.17	285,712	164	0.23
Savings accounts	213,927	51	0.09	193,267	68	0.14
Time deposits	526,314	1,973	1.49	663,613	3,436	2.05
Interest bearing deposits	1,332,911	2,226	0.66	1,402,097	3,763	1.06
Securities sold under repurchase agreements	7,164	1	0.06	1,930	-	-
Other short-term borrowings	652	-	-	2,865	-	-
Junior subordinated debentures	58,378	1,243	8.52	58,378	1,155	7.91
Subordinated debt	45,000	223	1.94	45,000	201	1.75
Notes payable and other borrowings	500	5	3.91	500	4	3.13
Total interest bearing liabilities	1,444,605	3,698	1.02	1,510,770	5,123	1.35
Noninterest bearing deposits	380,226	-	-	344,757	-	-
Other liabilities	28,130	-	-	23,738	-	-
Stockholders' equity	69,600	-	-	80,649	-	-
Total liabilities and stockholders' equity	\$ 1,922,561			\$ 1,959,914		
Net interest income (tax equivalent)		\$ 14,706			\$ 16,011	
Net interest income (tax equivalent) to total earning assets			3.44%			3.63%
Interest bearing liabilities to earning assets	84.84%			86.26%		

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1 Interest income from loans is shown on a tax equivalent basis as discussed below and includes fees of \$498,000 and \$448,000 for the third quarter of 2012 and 2011, respectively. Nonaccrual loans are included in the above stated average balances.

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ANALYSIS OF AVERAGE BALANCES,  
TAX EQUIVALENT INTEREST AND RATES

Nine Months ended September, 2012 and 2011

(Dollar amounts in thousands - unaudited)

	2012			2011		
	Average Balance	Interest	Rate	Average Balance	Interest	Rate
<b>Assets</b>						
Interest bearing deposits	\$ 48,871	\$ 89	0.24%	\$ 105,618	\$ 197	0.25%
Federal funds sold	-	-	-	713	1	0.18
Securities:						
Taxable	365,549	5,222	1.90	134,596	2,691	2.67
Non-taxable (tax equivalent)	10,417	467	5.98	13,364	590	5.89
Total securities	375,966	5,689	2.02	147,960	3,281	2.96
Dividends from FRB and FHLB stock	12,562	228	2.42	13,934	216	2.07
Loans and loans held-for-sale 1	1,293,533	51,741	5.26	1,575,039	62,024	5.19
Total interest earning assets	1,730,932	57,747	4.39	1,843,264	65,719	4.70
Cash and due from banks	27,528	-	-	34,023	-	-
Allowance for loan losses	(46,824)	-	-	(73,201)	-	-
Other non-interest bearing assets	236,281	-	-	238,975	-	-
Total assets	\$ 1,947,917			\$ 2,043,061		
<b>Liabilities and Stockholders' Equity</b>						